



# SPECIAL REPORT SERIES: TRANSACTION REPORTING OF INSTRUMENTS

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This Special Report is the eighth in the FIA and FIA Europe's series covering specific areas of the European Securities and Markets Authority's ("ESMA") consultation process for the implementation of the recast Markets in Financial Instruments Directive ("MiFID II") and Regulation ("MiFIR"). It provides an overview of the proposals relating to transaction reporting, as set out in the recently published Discussion Paper<sup>1</sup> including ESMA's reasoning and questions on the future Regulatory Technical Standards ("RTS") and Implementing Technical Standards ("ITS").

## OVERVIEW OF THE REPORTING REQUIREMENTS

MiFID II and MiFIR introduce new requirements relating to transaction reporting, i.e. notifying the competent authority of identifying reference and post-trade data, for investment firms that execute transactions in financial instruments. The Discussion Paper covers five aspects of the reporting obligation: the obligation to report transactions; the obligation to supply financial instrument reference data; the obligation to maintain records of orders; the requirement to maintain records of orders for firms engaging in high frequency algorithmic trading techniques; and the synchronisation of business clocks. This Special Report focuses on the first of those obligations, which is included in Article 26 of MiFIR.

## THE OBLIGATION TO REPORT TRANSACTIONS

Article 26(1) of MiFIR requires investment firms "executing transactions in financial instruments" to report to the national competent authorities ("NCAs") details of those transactions in order to enable the NCAs to detect and investigate potential instances of market abuse, and to help the NCAs monitor the functioning of markets and investment firms' activities.

Under Article 26(7) of MiFIR, investment firms may file the reports directly, through an Approved Reporting Mechanism ("ARM"), or the trading venue through which a transaction was completed. Reporting to a trade repository under EMIR would also satisfy the MiFIR reporting obligation, provided that the EMIR report contains at least the same information as the one required by MiFIR.

Pursuant to Article 26(3) of MiFIR, the transaction reports should include among others the following details (i) information on the financial instruments bought or sold; (ii) identification of the client on whose behalf the investment firm has executed the transaction; (iii) identification of the investment firm as well as the person and the computer algorithm within the investment firm responsible for the investment decision and the execution of the transaction; and (iv) designation to identify short sales. MiFIR tasked ESMA with developing RTS in relation to the above-mentioned aspects of the reporting obligation.

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<sup>1</sup> ESMA Discussion Paper (ESMA/2014/548).

## *Execution of a Transaction*

The Discussion Paper outlines a number of principles for determining whether an investment firm has executed a transaction for the purposes of the MiFIR reporting obligation. According to ESMA, a “transaction” means any change -- not related to corporate actions or valuations -- in an investment firm’s position and/or their client’s position in a reportable financial instrument.

The concept of “execution of a transaction” for the purposes of the reporting obligation is broader than market-side trades; according to ESMA, this concept covers all actions necessary to effect the transaction concluded between the final intermediary and the trading venue or investment firm where the order was ultimately filled. Accordingly, ESMA proposes to define “execution” as any action that results in a transaction.

Such actions would include (i) purchases or sales of a reportable financial instrument; (ii) assignments, novations, or terminations of a reportable financial instrument, and compressions or entering into a derivative contract in a financial instrument; (iii) exercises of options, warrants, or convertible bonds; and (iv) when acting under a discretionary mandate in connection with a portfolio or on behalf of a client, undertaking any of the preceding actions or instructing another party to do such actions, pursuant to an investment decision by the investment firm. These actions would be considered an “execution of a transaction” irrespective of whether they were performed directly by the investment firm itself or through a third party; whether they took place on a trading venue; or whether the investment firm undertook them as principal or as agent for the account of, and on behalf of, a client.

To better illustrate its reasoning, ESMA lists certain other actions which should be considered as “execution of a transaction” and some actions which do not qualify as such.

## *Transmission of an Order*

Under Article 26(4) of MiFIR, investment firms that transmit orders (i.e. firms that pass on details of orders received from their clients to other investment firms and firms acting on a discretionary basis that place orders with other investment firms) must include the reporting details in the transmission of those orders, unless they report the orders themselves. ESMA proposes that the order should be considered as “transmitted” only if (i) the transmitting firm sent to the receiver the identifying information specified in Article 26 of MiFIR;<sup>2</sup> (ii) there is a written agreement between the order transmitter and the receiver that specifies the circumstances under which the relevant details will be considered as passed and confirms that the order receiver is an European Economic Area (“EEA”) investment firm with reporting responsibilities and that it will send a transaction report that contains the details passed on by the order transmitter; (iii) the details have been passed in accordance with that agreement; and (iv) the order transmitter has adequate systems and controls to ensure that the information it transmits is complete and accurate.

## *Reporting by Branches*

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<sup>2</sup> The fields required under paragraphs 1 and 3 of Article 26 of EMIR would include: (i) information on the financial instrument; (ii) buy/sell indicator; (iii) quantity and price and any conditions such as limit price, minimum quantity etc. (iv) client information (designation and additional details on decision maker and beneficiary); (v) short selling information relating to the client; and (vi) where the order is aggregated for several clients the information must be provided for each allocation.

Current MiFID provisions determine the reporting obligations of branches based on whether the relevant service was provided by the branch within the territory of the Member State in which the branch is located. In practice, this means that branches report some transactions to the host NCA and some transactions to the home NCA, as required by the rules established by the individual Member States. As a result, on occasion, the same transaction reports were submitted to both the home and the host NCAs and, in some cases, transactions were not reported at all.

MiFIR tasked ESMA with establishing harmonised rules on reporting that are applicable to branches of investment firms. In the Discussion Paper, ESMA notes that according to MiFID II, the host NCAs are responsible for ensuring that the services provided by a branch within their territories comply with the reporting obligation and must have access to the relevant information to supervise the branch. ESMA proposes that the head office of the branch first reports the transaction to the home NCA; subsequently, the home NCA will share the relevant information with the host NCAs chosen by taking into account: the most liquid market of the instrument; the host Member State of the branch that holds/maintains the client relationship; the host Member State of the branch of the executing trader; and the host Member State of the branch that holds the membership of the trading venue where the transaction was conducted.

## FINANCIAL INSTRUMENTS COVERED BY THE REPORTING OBLIGATION

Pursuant to Article 26(2) of MiFIR, the reporting obligation applies to (i) financial instruments that are admitted to trading or traded on a trading venue or for which a request for admission to trading has been made; (ii) financial instruments where the underlying is a financial instrument traded on a trading venue; and (iii) financial instruments where the underlying is an index or a basket composed of financial instruments traded on a trading venue. Those transactions should be reported even if they are not carried out on the trading venue.

MiFIR tasked ESMA with developing RTS to specify the relevant categories of financial instruments that must be reported. ESMA's reasoning is outlined in the Discussion Paper. In the specific case of financial instruments over indices or baskets, ESMA is of the view that where those financial instruments are admitted to trading or traded on a trading venue, or where a request for admission has been made, the financial instruments will always be considered as reportable, regardless of the composition of the index or basket. For baskets, ESMA proposes that investment firms shall be required to report the transaction where *at least one* of the financial instruments in the basket is traded on a trading venue. For indices, ESMA outlines three possible approaches. Specifically, investment firms would have to report the transaction: (i) where all components of the index are traded on a trading venue; (ii) based on a threshold (for example, where at least 50% of the index, based on weighting, is traded on a trading venue); or (iii) where the index is used as the underlying for a financial instrument captured by Article 26(2)(a) of MiFIR. ESMA seeks the industry's views with respect to the above options.

## TRANSACTION REPORTS

Article 26(3) of MiFIR lists a number of fields that must be populated in a transaction report; some of those fields are to be defined in RTS drafted by ESMA. The Discussion Paper includes a sample table with all fields of a transaction report (Annex 8.1.1) and ESMA's views with respect to certain specific fields. We summarize some of ESMA's views below.

### *Client Identification*

MiFIR obliges investment firms to report to the NCAs a designation to identify the clients on whose behalf the investment firm has executed the transaction, together with further details of the identity

of the client. In the Discussion Paper, ESMA notes that while the pre-existing MiFID rules established at the EU level did not oblige investment firms to report client details, Member States could impose such requirement under their national laws with respect to firms within their jurisdiction. ESMA proposes to leverage the national identifiers instead of developing a single EEA-wide client identifier. The Discussion Paper then details ESMA's views on the client identifiers, as applicable to clients that are (i) natural or (ii) legal persons.

### *Trader and Algorithm ID*

The Discussion Paper also details ESMA's reasoning relating to the identification of (i) the persons responsible for the decision making and trade execution ("Trader ID") and (ii) the computer algorithms responsible for the decision making and trade execution ("Algo ID"). In relation to the Algo ID, ESMA notes that algorithms change very quickly and proposes that investment firms should have responsibility and discretion over how they identify their algorithms throughout the algorithms' lifecycle. This discretion would be conditional upon (i) the Algo ID meeting certain criteria outlined in the Discussion Paper and (ii) the investment firm retaining adequate records about the algorithm, including a description of the nature of the algorithm and the trading strategy or strategies that the algorithm has been deployed to undertake.

### *Designation to Identify Short Sales*

MiFIR introduces the obligation to report short sales in relation to shares or sovereign debt, as defined in the EU Short Selling Regulation (the "SSR"). ESMA is of the view that an investment firms should specify in the report that it has executed a short sale either where the investment firm has itself entered into a covered short sale (either by pre-borrowing the financial instruments to be sold or by entering into an agreement/making an arrangement that covers the short sale), or where it is acting as a financial services provider and is executing a transaction on behalf of its client who has ordered the execution of a short sale transaction.

ESMA considers that where an investment firm is subject to the reporting obligation under MiFIR, but it is not subject to a restriction on uncovered short sales under the SSR, it should explain in the MiFIR report that it has executed a short sale while performing an activity that is exempted from the relevant provisions of the SSR.

ESMA then notes that certain short selling regimes in certain third countries impose an obligation for clients to disclose to their broker whether their sale is a short sale, which then enables the investment firm to accurately disclose this information to the relevant authority on the client's behalf. In the Discussion Paper, ESMA outlines two possible options to address the flagging of short sales. First, the implementing rules could require the investment firm to determine whether the client is making a short sale on a best efforts basis; this would involve the investment firm asking the client whether the sale is a short sale and the client voluntarily disclosing the information. Second, the implementing rules could require the investment firm to flag short sales solely on the basis of the information that the investment firm already possesses about the client's holding in their own systems.

ESMA also discusses the flagging of short sales where the investment firm is acting in a principal capacity. ESMA notes that where the investment firm is buying from the client as principal and the client is short, there is a question of whether an investment firm should flag that a short sale has taken place. According to ESMA, one possible approach in that case is to require investment firms acting in a principal capacity only to mark their transaction reports with a short sale flag where the investment firm has short sold shares or sovereign debt. This approach would mean that, in cases where the investment firm has bought from the client (who is short selling) on a principal basis, this

short sale would not be flagged in the investment firm's transaction report. The alternative approach would be to require the investment firm to use the short sale flag whenever the investment firm or the client has short sold in that transaction. ESMA appears to favour the first approach.

Finally, ESMA discusses the treatment of aggregated orders by investment firms acting in an agency capacity. ESMA proposes that, for the market side leg, the investment firm should not use the short sale flag for the aggregated transaction. For the individual client legs ESMA proposes that the investment firm should use the short sale flag depending on whether the individual client is short or not.

## UPCOMING SPECIAL REPORT

In the coming days, FIA and FIA Europe will issue the ninth and final special report on the remaining topic addressed in the two papers:

- **Transparency Requirements for Instruments**

## UPCOMING ESMA HEARINGS: COMMODITY DERIVATIVES, MARKET ISSUES, AND INVESTOR PROTECTIONS

As a reminder, ESMA will hold an open hearing on commodity derivatives on 8 July 2014. Additional details on the hearing are located [here](#). ESMA will also hold open hearings on market issues on 7 July 2014 and investor protection issues on 8 July 2014. Additional details on these hearings are located [here](#).

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Additional MiFID II/MiFIR documents are available [here](#).

*Disclaimer: This report was drafted by the London office of [Covington & Burling LLP](#) on behalf of FIA and FIA Europe. The report is part of a series of reports intended to provide factual summaries of MiFID/MiFIR on certain topics of interest to the members of FIA and FIA Europe. The reports are provided for general informational purposes only. They do not constitute legal or regulatory advice and should not be relied upon for this purpose.*

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