London Stock Exchange Group

The Evolution of EEA Transaction Reporting

UnaVista

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The Evolution of EEA Transaction Reporting

£13.28m

fine against Merrill Lynch International[1]

On the face of it, transaction reporting is not the most exciting subject. There is a danger that some firms might treat it as a pointless box ticking exercise that can be satisfied with the minimum control or oversight. It appears that one firm in the UK took this to the extreme and not only failed to report any transactions for over three years, but also had inadequate systems and controls and a complete absence of documented procedures over transaction reporting. The FCA duly punished the firm for this oversight.

For the regulators, transaction reporting is a far from dull subject. Instead, it an essential tool that allows them to meet some of their most important regulatory objectives in monitoring for market abuse and maintaining orderly markets. To put it simply, without transaction reporting, regulators would be blind to market transactions and any abuse that might occur.

It is an indication of its significance that the FCA has taken a strong enforcement stance against transaction reporting failures, as demonstrated by the string of sanctions imposed by the FCA culminating with the recent £13.28m fine against Merrill Lynch International.1 In announcing this fine, the FCA made a very clear statement that:

> "Accurate and timely reporting of transactions is crucial for us to perform effective surveillance for insider trading and market manipulation in support of our objective to ensure that markets work well and with integrity."

Clearly the regulators treat transaction reporting as a very important topic and one that firms need to take very seriously to avoid possible sanctions.

[1] https://www.fca.org.uk/news/fca-fines-merrill-lynch-international-for-transaction-reporting-failures

A brief history of transaction reporting

Transaction reporting within the EEA can trace its history back to 1993 and the Investment Services Directive.[2] Article 20 of the ISD required firms to report transactions in certain debt and equity instruments to home state competent authorities within T+1. The UK's Securities and Futures Association modified its Rule 5-49 in relation to transaction reporting to reflect the ISD, increasing the number of financial instruments that were subject to reporting and increasing the amount of detail to be contained within a report. The increasingly onerous nature of transaction reporting continued when MiFID became effective in 2007 and is set to grow further with MiFIR.

Transaction Reporting under MiFID

MiFID Article 25 places an obligation on Competent Authorities (CAs) to uphold the integrity of the markets and requires investment firms to report transactions and maintain records.

In particular, Article 25(3) states: "Member States shall require investment firms which execute transactions in any financial instrument admitted to trading on a regulated market to report details of such transactions to the competent authority as quickly as possible, and no later than the close of business the following working day."

The actual reportable instrument set is perhaps one of the most confusing elements of transaction reporting. For a start 'regulated market' under MiFID actually means an **EEA** regulated market and although MiFID states "**any** financial instrument admitted to trading on a regulated market" a decision was taken by the Commission to restrict the reportable instrument set to 'securities related' instruments – i.e. any FX, commodity or interest rate derivative is currently outside the scope of MiFID transaction reporting.

Unlike the ISD, MiFID is a maximum harmonisation directive, but this hasn't prevented many of the national competent authorities interpreting the Directive in different ways when transposing it into their rulebooks. The FCA's transaction reporting requirements are detailed in Chapter 17 of the FCA Handbook Supervision Manual (SUP17) and these are 'super-equivalent' to MiFID in that it has extended the reportable instrument set in two important areas:

1. Securities related instruments admitted to trading on 'prescribed markets' – in addition to EEA regulated markets, this captures markets established under the rules of a UK-recognised investment exchange such as the Alternative Investment Market (AIM).

2. Any OTC derivative whose value is dependent upon securities related instruments admitted to trading on a regulated/prescribed market – e.g. a contract for difference on Vodafone common stock.

[2] http://www.esma.europa.eu/system/files/Dir_93_22.PDF

14million

transaction reports a day[4]

Content of a transaction report

There are 23 or 24 fields that comprise a transaction report and these are set out in Article 13 of MiFID Implementing Regulation[3] and its Annex 1. The slight anomaly in the number fields results from the optionality of the 'client' field – MiFID gives national competent authorities the option on whether to require a client identifier or not. The FCA has taken the view that the client identifier is an essential component for detecting market abuse, so it includes this field. Other authorities collect even more fields – for example, there are over 60 data elements in a report to the BaFin.

The core fields are set out in MiFID Article 25 and this states that reports shall include details of the names and numbers of the instruments bought or sold, the quantity, the dates and times of execution and the transaction prices and means of identifying the investment firms concerned. Many of the additional fields set out in the Implementing Regulation relate to the characteristics of the financial instrument of the report being made. For example, there are fields for the exercise date, underlying instrument, put/call identifier in case the transaction being reported relates to an option. However, not all the fields that comprise a transaction report need to be populated as one of the key features of transaction reporting is that regulators will not ask for reference data relating to the characteristics of a financial instrument if the regulators already possess that reference data. Since regulated markets are obliged to send reference data to their regulator for all securities related instruments admitted to trading on their exchanges, it means that firms do not need to send this additional reference data in their reports other than to identify the financial instrument either with an ISIN or the elements that comprise the Alternative Instrument identifier.

What do the regulators do with the data?

As detailed earlier, one of the main objectives of transaction reporting is to enable the competent authorities to detect and pursue suspected instances of market abuse. The FCA receives approximately 14 million transaction reports a day[4] and it is reliant on sophisticated algorithms to detect abuse and market dislocations. Clearly, these algorithms will only produce the desired results for the FCA if it receives accurate reports from the reporting firms.

The FCA also shares this data with other competent authorities where it is not the home state regulator for the reporting firm (e.g. reports from the London branch of Deutsche Bank will be shared with the BaFin) or if it is not the 'relevant competent authority' for the instrument that is subject of the report (e.g. reports of transactions in Total SA will be shared with the AMF).

[3] http://www.fca.org.uk/static/pubs/international/mifid-level-2-regulation.pdf

[4] As detailed in a FCA transaction reporting forum, May 2014 http://www.fca.org.uk/static/documents/transaction-reporting-update-may-14.pdf

Regulatory Approach

firm fined

£5.6m

in 2013

firm fined

£13.6m

in 2015

In January 2007 the FCA issued its Policy Statement 07/02 that detailed the FCA's responses to their proposals for Transaction Reporting and detailed its final policy decisions with regards to MiFID implementation due in November 2007.

In the countdown to MiFID, FCA published Market Watch Issue Nº 19 which drew firms attention to the changes laid out in the Policy Statement, introduced proposals to produce the first Transaction Reporting User Pack and took an opportunity to remind firms to regularly review the integrity of their transaction report data by asking the Transaction Monitoring Unit for sample transaction reports which firms were encouraged to check against their own internal records.

In May 2007, Market Watch Issue Nº 20 further detailed developments to the Approved Reporting Mechanism regime and yet again FCA took the opportunity to remind firms to check their data and ask for sample reports. This was followed up with another detailed Market Watch issued in August 2007 Issue Nº 22 that provided firms with details as to the cut over to the new Transaction Reporting regime, a confirmation that as had been previously indicated that FCA would be prepared to take a proportionate approach in respect of certain requirements.

Our reason for highlighting these particular formal communications from the FCA to industry at the time of MiFID implementation is to demonstrate quite how seriously FCA took transaction reporting before MiFID in that specific reference was made to the new regime in 4 out of 6 Market Watches ahead of go live. These specific publications being in addition to the guidance found in the Transaction Reporting User Pack (TRUP) and in addition to the many other industry briefings that were also held at time.

The FCA appeared to let the new regime bed in, yet it was apparent from the tone of the next Market Watch that the situation was about to change. Once again the FCA took the opportunity to suggest firms check their data yet this time the suggestion was accompanied by a warning.

FCA declared that they would be undertaking regular reviews of the quality and completeness of firms' submissions and that they now expected firms now to be fully compliant with the transaction reporting requirements set out in the regulations. Furthermore the FCA for the first time noted that where problems with transaction reporting were identified, then they would be considering the use of enforcement tools and clearly directed firms to focus on their systems and controls and transaction reporting monitoring programme.

Despite the FCA's declarations and warnings, it felt that some market participants weren't taking adequate measures to ensure their reporting was accurate and complete. Whilst the FCA wanted to work with firms to improve the quality of the data it received and shared with other NCAs, it had become clear this approach wasn't working. The FCA's patience had clearly run out and from September 2009 through to August 2010 the FCA fined a total of 6 firms for failures to correctly make transaction reports.

In some cases the fine was levied to cover not only the data quality breaches under the Regulation itself but also where firms had breached an FCA Principle by not having adequate systems and controls in place to meet the transaction reporting requirements. Each time the message from the FCA was clear.

FCA has, since that initial wave of enforcement actions, continued to find fault fining a firm GBP 5.6million in 2013 and one in 2015 GBP 13million

Firms' Reporting Framework, Systems & Controls

Ahead of the first wave of enforcement actions in 2009 – 2010, it may be fair to suggest that there had not been sufficient focus on the quality, accuracy and timeliness of firms' transaction reports.

Firms had likely run large MiFID implementation programs and Transaction Reporting had likely been a key part of that program but once the code had been tested, released and the reporting went live it became apparent that adequate systems and controls had not been put in place to ensure ongoing compliance with the requirements.

The initial enforcement actions spurred many firms into action and efforts were made to resolve issues before the FCA pointed out failings for themselves.

In October 2008 Issue Nº 29 FCA described in detail what reporting arrangements they expected to see within firms.

"Firms must meet specified standards when reporting transactions to us in terms of the submission of reports and their content. To ensure accuracy and completeness, firms, under SYSC in the Handbook (Senior Management Arrangements, Systems and Controls) and under Principle 3 (Management and Control), must have appropriate systems and controls in place to enable them to comply with their regulatory obligations"

We won't detail the entire list of recommendations but by way of example:

- a clear allocation of responsibility for transaction reporting within an organisation;
- appropriate training for staff in respect of transaction reporting;
- appropriate information produced on a regular basis to enable proper oversight of the transaction reporting process;
- processes for ensuring continued transaction reporting accuracy and completeness post any system or process changes;
- appropriate oversight of transaction reporting by compliance including reviews as part of the compliance monitoring programme;

Further the later editions of the TRUP first issued in 2007 and subsequently revised also detailed the FCA's expectations. Again exhaustive lists are provided but by way of example;

- reviews and testing that are tailored to the nature and scale of activities of the organisation and its transaction reporting arrangements
- regular validation of static data to ensure static data integrity
- documentation detailing transaction reporting processes and the relevant systems and controls
- where sample testing is employed in a firm's reconciliation processes, care should be taken to select transaction report samples that are representative of the firm's full trading activity and

In order to meet best practice, firms have implemented often large scale change programmes in order to ensure continuous compliance with the timeliness, completeness and accuracy requirements. Firms have system infrastructures of varying degrees of complexity hence the control frameworks now in place will be tailored to reflect this. Firms in the run up to MiFID had multiple reporting channels that were built on legacy platforms and had evolved over time. In many cases firms were using multiple ARMs to report different asset classes; these have now been replaced with hub architectures embodying central repositories of transaction data where single sets of business rules are applied to determine whether a transaction should or should not be reported accompanied by single validation and enrichment engines to ensure a consistency in the formats of the reports that are made leading to reduced cost and risk of dealing with exceptions.

Whilst it is not possible to detail all elements of a control framework in this article we have tried to outline the core constituents that firms should consider as part of a review program. In essence these core consituents should be applied to any reporting obligation and deployed according to the risk profile of the reporting obligation. MiFID Transaction reporting will for many firms fall into the high risk category.

> “Firms must meet specified standards when reporting transactions to us in terms of the submission of reports and their content.”

In most cases the production of transaction reports should be a straight through automated process and the functional technological solution should incorporate the following core components:

- The primary component serves to source the transactional data from the firm's transaction processing infrastructure. The source systems should be in themselves golden sources for either asset classes, specific business lines or specific entities.
- The second component ingests the transactions and applies a single set of centralised business rules to in order to minimise the risk of inconsistent application of business rules. Ingestion requires exception management processes.
- The third component provides enrichment of the transaction data with consistent reference data sourced from golden source systems whose data is maintained by specialised reference data processes elsewhere in the firm.
- The fourth validates data and ensures that messages are consistently populated according to the regulation and ensures that the data is logical. Validation checks can also be made to root out illogical data combinations for example trade times from exchanges that are out of exchange opening hours.
- The fifth manages the messaging and routing of the reports to the Approved Reporting Mechanism and incorporates appropriate response handling and further exception management routines.

Around these core components are exception management processes, processes to produce management information and the ability to set tolerance thresholds. Key to ensuring the integrity of the data is the reconciliation processes designed to ensure that everything that should have been reported was reported.

Regular reconciliations against data sourced directly from the regulator should also be carried out.

On top of this is the user interface which allows users to manage exceptions, view MI, monitor tolerance and extract data for analysis and troubleshooting purposes.

There are however continuous checks that need to be made once the automated reporting infrastructure has been set up to ensure the reporting continues to run smoothly. For example front to back quality assurance testing, continuous revision of rules and filters to ensure they remain appropriate, frequent reference data checks to ensure data is being applied correctly, detailed scenario analysis from order receipt through to transaction report to ensure that all the business use cases are being reported correctly.

Alongside the automation should also sit a robust Roles and Responsibilities Framework, user training and, in some cases, firm wide training to ensure a high level of awareness of the reporting function across all personnel involved in booking and managing transactions across the firm.

MiFIR – a Siginificant increase in Reportable Fields and Product Scope

Following the financial crisis and the legislated for reviews of MiFID1, MiFID 2 has been a long time coming. It is due for go live on January 3rd 2018 and contains, amongst many other measures, a substantial revision of the Transaction Reporting requirements.

The changes to the MiFID Transaction reporting regime are significant and can be divided into seven main areas.

From Directive to Regulation

MiFID was implemented into European Law, but then as a Directive could be open to interpretation when transposed into individual countries' national law. Hence the regime was implemented in as many different ways as there are countries in the EU.

In order to harmonise the reporting regimes across the EU and to facilitate the sharing of reports across European countries, the new regime is written into a Regulation and hence will enter directly into Member States' law with no room for interpretation and no room for gold plating.

Introduction of an ARMs Regime

MiFID formalises the law governing organisations that act as conduits between Investment Firms with an obligation to transaction report and National Competent Authorities. The original ARM regime was implemented by FCA in the UK and doesn't exist in the same way in many other Member States. The other Member States often allow firms to directly transmit reports to them. Perhaps unfortunately this piece of legislation was not incorporated into the Regulation hence ARM regimes may arise under different guises following implementation into national law by Member States. Although an ARM authorised in one Member State should be able to passport its services into other Member States without need for additional authorisation, there is a concern that there may not be a totally level playing field across the EEA.

The introduction of an ARMs regime implies that ARMs will become formally regulated entities and, potentially, at risk to sanctions if they fail to meet the required standards.

Reportable Products

MiFIR extends the scope of reportable products to:

- Financial instruments admitted to trading or traded on a Trading Venue or for which a request for trading has been made. A Trading Venue is a Regulated Market, MTF or OTF.
- Financial instruments where the underlying is a financial instrument traded on a trading venue.
- Financial instruments where the underlying is an index or a basket composed of instruments traded on a trading venue.

Quite clearly, this is a very significant increase in the number of financial instruments that will become reportable. Not least, it will add all the FX, commodity and interest rate listed derivatives that were excluded from current MiFID reporting. There is also a large number of North American and Asian instruments traded on MTFs, which will now become reportable, irrespective of on which venue they actually trade. The changes will also formalise the reporting of OTC derivatives, which brings a number of additional complexities for many market participants.

Reportable Fields

MiFID 1 required only 23 or 24 fields to be populated on a transaction report. MiFIR has now significantly increased this to 65 fields. MiFIR requires additional information about the parties to a transaction, for example the investment decision maker, the trader responsible for the execution and details of any algorithms involved.

> “Quite clearly, this is a very significant increase in the number of financial instruments that will become reportable.”

The regulation requires for significant amounts of information relating to individuals which will cause firms to have to make significant changes to the way reporting data is handled within their infrastructure because of the associated data protection concerns.

Reportable Transactions

MiFIR goes further than MiFID1 in defining transaction and defining execution.

A transaction is defined as an acquisition, disposal or modification of a reportable financial instrument and execution is the activity by an investment firm that results in a transaction. The principle is that the regulation seeks to capture any change in an investment firm’s position or their client’s position in a reportable financial instrument.

Execution is therefore no longer just a purchase or a sale of a financial instrument, but will now include activities such as:

- Increases and decreases in notional amount are included as separate transactions
- Exercise of options, warrants or convertible bonds

Entities with an Obligation to Report

This has been significantly extended to include branches of EEA investment firms trading outside the EEA and branches of 3rd country firms trading within the EEA. Trading venues will also have a reporting obligation as they will need to report on behalf of any remote members who are not caught by MiFIR as they are non EU investment firms operating outside of the EEA.

Removal of the Portfolio Manager’s Exemption

Buy side firms in the UK undertaking discretionary portfolio management business were able to take advantage of what is as known as the Portfolio Manager’s Exemption[5] and not make a transaction report where they faced a MiFID Regulated firm in the EEA.

The removal of this exemption means that these firms will now have to make transaction reports and will need to identify their clients within the 65 reportable fields. This requirement to identify the client means that these firms will have to report at the allocation level whereas previously these firms could report at the block level.

Many, but not all, investment managers take advantage of the exemption, but will no longer be able to do so with the introduction of MiFIR as this exemption will be ‘harmonised out’.

However, MiFIR does provide a means enabling investment managers to avoid making a transaction report when the face a MiFID Regulated broker by defining them as a Transmitting Firm. Transmitting firm means an investment firm that receives an order from a client or clients and sends it to a third party to be filled **or places an order with a third party when acting on a discretionary basis**.

Therefore, firms that transmit orders can enter into bilateral agreements with firms receiving those orders who will then make adjustments to the contents of their own reports accordingly to reflect the fact that the report has been made in accordance with ‘Receiving and Transmission of an Order’. In order for the conditions of the regulation to be fulfilled, the Transmitting firm will have to transmit additional data to the receiving firm including client, investment decision maker identification and whether the transaction was a short sell.

Buy side firms might consider that transmitting this additional data to their sell-side broker within T+1 is every bit as onerous as reporting the transaction in their own right, particularly since they will have to make their own reports when dealing with a non-EEA broker anyway.

[5] Detailed in section 17.2.2 of the FCA Handbook Supervision Manual (SUP17)

Regulatory Reporting Overlap – MiFIR and EMIR

At first glance, there appears to be a significant reporting overlap between the current EMIR trade reporting and MiFIR reporting. Each regime has a T+1 reporting requirement and the EMIR reporting regulatory technical standards Article 1(2) takes the definition of a transaction from MiFID[6]. The Commission doesn’t want to make regulatory reporting overly onerous and seeks to address overlap this by waiving MiFIR derivative transaction reporting obligations if both the following conditions are satisfied:

1. An investment firm has submitted reports to trade repositories containing all the required information for transaction reporting purposes
2. The trade repository submits the information as a transaction report to the correct competent authority as a MiFIR Approved Reporting Mechanism (ARM).

It appears, therefore, that firms may only need to report their derivative transactions to a Trade Repository to satisfy their MiFIR derivative reporting requirements. However, even if the trade repository reports to the correct CA, there are some fundamental issues preventing the conditions from being satisfied. Firstly, the field set differs between EMIR and MiFIR. Whilst MiFIR and EMIR both have the same number of fields defined in the regulatory technical standards, these fields differ significantly.

For example, EMIR doesn’t include fields such as short selling flag, identification of waivers, and an array of trader and algorithm identifiers. This is potentially surmountable if the reporting firm sent a superset of data through to a data aggregator or trade repository that would satisfy both EMIR and MiFIR reporting requirements. However, as the MiFIR reporting requirements have developed through the consultation process, we have seen further divergence between the two regimes, particularly on the very definition of what constitutes execution of a transaction. Many see this as a natural result on the different regulatory purposes behind the regimes: EMIR trade reporting is primarily focussed on the identification of systemic risk whereas MiFIR transaction reporting is primarily focussed on the detection of market abuse. This is perhaps most starkly realised when considering the role of executing brokers and clearing members. Under MiFIR, the obligation is on the executing broker to report rather than the clearing member. Under EMIR, it is the opposite – the clearing member has the obligation rather than the execution broker, providing the trade is given up for clearing within the day of trading. The definition of transaction also appears to differ between the regimes for certain OTC derivatives. EMIR views partial terminations of some OTC derivatives as a modification to the existing transaction whereas MiFIR sees it as a new transaction separate to the original transaction.

[6] RTS Article 1(2) conclusion of a contract shall mean ‘execution of a transaction’ as referred to in Article 25(3) of [MiFID]

Prepare for MiFIR now

The evolution of transaction reporting has often proved painful for many firms. The process has often been beset with problems interpreting a set requirements influenced by all the EU Member States. This process has been complicated by a lack of common definition or understanding of fundamental concepts such as 'give-ups', 'trading capacity' and even 'execution of a transaction' across borders.

It is evident that firms struggle with current MiFID transaction reporting, given the continued flow of sanctions levied by the FCA for transaction reporting failures. This is a mature regime, over eight years old, which only covers securities transactions with a report comprising 24 fields. MiFIR raises the complexity of transaction reporting to a completely different level, covering all asset classes and dramatically increasing the number of fields of fields to be reported. An implementation date of January 2018 may seem a long way off, but firms need to start preparation now if they are to meet these new reporting requirements successfully.

> "This is a mature regime, over seven years old, which only covers securities transactions with a report comprising 24 fields."

[5] Detailed in section 17.2.2 of the FCA Handbook Supervision Manual (SUP17)

About the authors

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David Nowell is Head of Industry Relations and Regulatory Compliance for UnaVista at the London Stock Exchange. He has over 20 years financial services experience on both sides of the regulatory fence, having worked previously for the FSA, Reuters and Credit Suisse. At Credit Suisse, he was Transaction Reporting Manager, responsible for ensuring compliance across all aspects of the reporting process and advising on new regulatory requirements. Prior to this, David was a Technical Specialist within the Transaction Monitoring Unit at the FSA, where he was responsible for shaping the transaction reporting rules and providing guidance to UK firms. David was the FSA's representative on transaction reporting in Europe for a number of years where he was intimately engaged in policy negotiations with other regulators, giving him a unique insight into the policy making process and the regulators' expectations of the industry.

David is the Compliance Officer and lead subject matter expert for the UnaVista Trade Repository, both helping customers with the reporting of all derivatives asset classes and ensuring UnaVista Trade Repository complies with the EMIR requirements. David has also introduced industry accredited training courses on the subjects of both MiFID transaction reporting and EMIR trade reporting to help the industry improve the quality of reporting standards.

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Matthew Vincent works for Credit Suisse as Head of UK Transaction Reporting. Prior to working at Credit Suisse, Matthew worked for Barclays Bank in the Operational Compliance Team advising on Regulatory Reporting including MiFID Transaction Reporting and EMIR Trade Repository Reporting. He has over 20 years' experience working in a variety of Front Office, Operations, Compliance and IT roles for a number of major firms. He is Chair of the BBA's Transaction Reporting Policy Working Group, a member of ESMA's Consultative Working Group and a Chartered Fellow of the Chartered Institute of Securities and Investment.

[6] RTS Article 1(2) conclusion of a contract shall mean 'execution of a transaction' as referred to in Article 25(3) of [MiFID]

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