Freshfields Bruckhaus Deringer

FSbriefing

MiFID 2: Transaction reporting

Summary

The revised Markets in Financial Instruments Directive (MiFID 2) and the new Markets in Financial Instruments Regulation (MiFIR) were approved by the European Parliament and European Commission in April/May 2014 and published in the Official Journal of the European Union in June 2014. Following several rounds of consultation, Level 2 legislation supporting MiFID 2 and MiFIR has been adopted by the Commission.

This briefing provides a refresher on the principal changes introduced by MiFID 2 and MiFIR in relation to transaction reporting and focuses on some of the key issues coming out of the relevant Level 2 legislation in the form of regulatory technical standards (RTS).

The texts of MiFID 2 and MiFIR are of EEA relevance and hence will be applicable to non-EU, EEA countries once incorporated into the EEA Agreement. Whether MiFID 2 and MiFIR will continue to apply in the UK, if the UK were to invoke Article 50 of the Lisbon Treaty and consequently leave the EU (Brexit), depends upon the future relationship of the UK and the EU. If the UK were to remain a member of the EEA following a Brexit, MiFID 2 and MiFIR would continue to apply once incorporated into the EEA Agreement; but in other scenarios, the UK would become a third country for the purposes of MiFID 2 and MiFIR, unless special terms were negotiated between the UK and EU.

If the UK becomes a third country for the purposes of MiFID 2 and MiFIR, it is likely to seek to utilise to the maximum the equivalence recognition provisions. The FCA has confirmed that firms should proceed with the implementation of MiFID 2 and MiFIR, which would enable the UK to demonstrate equivalence if necessary.

Following political agreement, the transposition and application date of MiFID 2 and MiFIR have been delayed to 3 July 2017 and 3 January 2018, respectively.

Key business impacts

Investment firms will have to:

- review and update their systems to ensure that transaction reports are made in respect of a wider range of financial instruments, encompassing a much more extensive set of details; and
- include branch transactions in transaction reports.

Introduction

Investment firms that execute transactions in financial instruments are required to report details of those transactions to a relevant competent authority. Unlike the equivalent obligation under the current MiFID regime, which applies only to financial instruments admitted to trading on a regulated market (RM), the requirement to transaction report under MiFIR applies to financial instruments (i) that are admitted to trading or traded on a trading venue (comprising RMs, multilateral trading facilities and organised trading facilities) or for which a request for admission to trading has been made, (ii) where the underlying is traded on a trading venue or (iii) where the underlying is an index or a basket composed of financial instruments traded on a trading venue.

The aim of the transaction reporting regime is to enable competent authorities to detect and investigate potential instances of market abuse, and to monitor the fair and orderly functioning of markets and investment firms' activities. Competent authorities will be required to make the information firms report available to the European Securities and Markets Authority (ESMA) upon request.

Level 2 measures on transaction reporting obligations are set out in:

- RTS 22 (2016) 4733: Reporting of transactions to competent authorities;
- RTS 23 (2016) 4405: Supply of relevant data relating to orders in financial instruments; and
- RTS 25 (2016) 3316: Level of accuracy of business clocks.

This briefing takes account, in addition, of the ESMA guidelines on transaction reporting, order record keeping and clock synchronisation (published 10 October 2016).

Meaning of 'transaction'

The concept of a 'transaction' is essential to defining the scope and application of the reporting obligation under MiFIR. RTS 22 provides further detail on the meaning of transaction which, broadly, is the conclusion of an acquisition or disposal of a financial instrument (i.e. the outcome).

A 'transaction' does not include the following:

- certain securities financing transactions under the Regulation on Reporting and Transparency of Securities Financing Transactions;
- contracts arising exclusively for clearing or settlement purposes;
- settlement of mutual obligations between parties where the net obligation is carried forward;
- acquisitions or disposals that are solely a result of custodial activity;
- post-trade assignments or novations of derivative contracts where one of the parties to the derivative contract is replaced by a third party;
- portfolio compressions;
- creations or redemptions of units of a collective investment undertaking (CIU) by the administrator of the CIU;
- exercising a right embedded in a financial instrument or the conversion of a convertible bond and the resulting transaction in the underlying financial instrument;
- creation, expiration or redemption of a financial instrument as a result of predetermined contractual terms, or as a result of certain mandatory events (but this exclusion will not apply to initial public offerings or secondary public offerings or placings, or debt issuance);

- decreases or increases in the notional amount of a derivative contract as a result of pre-determined contractual terms or certain mandatory events;
- changes in the composition of an index or a basket that occurs after the execution of a transaction;
- acquisitions under a dividend re-investment plan;
- acquisitions or disposals under an employee share incentive plan or arising from the administration of an unclaimed trust asset, or of residual fractional share entitlements following corporate events or as part of a shareholder reduction programme where certain criteria are met; or
- certain exchanges and tender offers on bonds or other forms of securitised debt.

ESMA's guidelines provide further useful detail on what is considered a transaction

It is worth noting that ESMA's guidelines provide further useful detail on what is considered a transaction for these purposes. Broadly, movements that do not result in a change of ownership (e.g. the movement from a client account operated under a discretionary mandate to one operated on an execution-only basis) would not be considered an acquisition or disposal and consequently are not reportable. The exception to this is the simultaneous acquisition and disposal specifically referred to in Article 2(4) of RTS 22 where there is a post-trade publication obligation.

Following earlier feedback on the MiFID 2 and MiFIR Discussion Paper, ESMA wrote to the European Commission in April 2016 requesting the explicit exclusion of collateral transfers from the definition of 'transaction'. While the exemption is missing from the most recent public version of RTS 22, we understand that the intention is to deal with this in corrigenda.

Meaning of 'execution'

In RTS 22 'execution' is limited to an exhaustive list of services or activities that result in a transaction being concluded.

An investment firm shall be deemed to have 'executed' a transaction, and therefore be in scope of the transaction reporting regime, where it provides any of the following services or performs any of the following activities that result in a transaction:

- reception and transmission of orders in relation to one or more financial instruments;
- execution of orders on behalf of clients;
- dealing on own account;
- making an investment decision in accordance with a discretionary mandate given by a client; or
- transferring financial instruments to or from accounts.

As the obligation to report falls on investment firms that execute transactions, where two investment firms trade with each other, both would be required to submit their own transaction report that reflects the transaction from their perspective.

Transmission of orders

Investment firms that execute transactions are required to submit transaction reports to the relevant competent authority. There is a limited exception to this requirement for firms that transmit orders to other investment firms, which may either choose to transmit all of the specified details to the investment firm to which they are passing the order or to report themselves. A firm will not be deemed to have executed a transaction where it has transmitted an order to a third party in accordance with the requirements set out below.

To avoid non-reporting or double reporting by firms that transmit orders to each other, they should agree between them which firm has the responsibility for making the transaction report. If there is no agreement the order should be deemed not to have been transmitted and each investment firm will be required to submit its own transaction report.

Certain conditions must be met for a firm to be deemed to have transmitted an order and be able to rely on a third party to report, namely:

- the order must be received from the firm's clients or result from the firm's decision to acquire or dispose of a specific financial instrument in accordance with a discretionary mandate provided to it by one or more clients;
- the transmitting firm must have transmitted certain order details to another investment firm (the receiving firm) as specified in Article 4(2) of RTS 22; and
- the receiving firm must be subject to the transaction reporting obligations under MiFIR and must have agreed either to report the transaction or to transmit the order details to another investment firm.

Transmission requirements are on an 'all or none' basis

ESMA's guidelines confirm that transmission requirements are on an 'all or none' basis. Therefore, if the transmitting firm fails to pass on all of the information required to meet the transmission conditions, the receiving firm should report as if there were no transmission.

The Commission has not specified the form of the agreement that would be required, but RTS 22 require that the agreement must:

- specify the time limit for the provision of order details by the transmitting firm to the receiving firm; and
- provide that the receiving firm shall verify whether the order details received contain obvious errors or omissions before submitting a transaction report or transmitting the order in accordance with RTS 22.

One of the key considerations for such an agreement is likely to be the way that liability is apportioned between the transmitting and receiving firms.

In addition, the guidelines clarify that:

Transmission cannot take place between branches of the same firm since they are not separate legal entities

- investment firms dealing on own account or on a matched principal trading basis are considered to be acting directly themselves and on that basis cannot 'transmit orders';
- where an order is aggregated for several clients, information must be transmitted for each allocation to a client; and
- transmission does not take place between branches of the same firm since they are not separate legal entities. In contrast, where transmission takes place between different legal entities within a group, the reporting requirements apply as if those entities were unrelated firms.

In addition ESMA considers circumstances in which a firm does not complete a transaction itself but instead sends the order to another firm for completion. Unless there is transmission of an order within the meaning set out above, ESMA's view is that the fact that a firm is part of a chain does not in itself impact its reporting obligations. The firm is required to report its 'part' of the chain only and therefore does not have to look forwards or backwards in the chain beyond its immediate counterparty and client.

Method of and responsibility for submitting transaction reports

Under the current MiFID regime any third party is able to make a transaction report on behalf of an investment firm. MiFIR transaction reports can be submitted to the competent authority only by the firm itself, by an approved reporting mechanism (ARM) acting on the firm's behalf or by the trading venue through whose system the transaction was executed. This change reflects the perceived need to regulate the provision of core market data services to ensure the necessary level of quality for users to obtain an overview of trading activity across EU markets and for competent authorities to receive accurate and comprehensive information on relevant transactions.

Where an investment firm arranges for another person (including an ARM) to submit transaction reports on its behalf, the firm must take reasonable steps to verify the completeness, accuracy and timeliness of the transaction reports. But where an investment firm uses an ARM or a trading venue to transaction report, the firm will not be responsible for failures in the completeness, accuracy or timely submission of the reports attributable to the ARM or trading venue. Where there are errors or omissions in transaction reports, the investment firm, ARM or trading venue is obliged to correct the information and submit a corrected report to the relevant competent authority.

In circumstances where a firm is required to report a transaction for the purposes of both MiFIR and the European Markets Infrastructure Regulation (EMIR), reports submitted to a trade repository under EMIR that is also approved as an ARM under MiFIR will be sufficient to satisfy the firm's MiFIR obligations, provided that the reports contain sufficient information as required under MiFIR.

Timing for submission and content of reports

Transaction reports must be sent to competent authorities as quickly as possible and no later than close of the working day following the day on which the transaction was executed. This is regardless of whether the report is made directly by an investment firm, an ARM acting on its behalf or by the trading venue through whose system the transaction was completed. Firms therefore need to submit information in time for the venue or ARM to submit the report no later than 23:59:59 local time on the working day following the day of the transaction. Working days exclude Saturdays and Sundays and official national holidays in the member state of the competent authority to whom the transaction report is submitted.

Transaction reports will be required to include a large number of additional fields

Under MiFIR transaction reports will be required to include a large number of additional fields, including detailed information in respect of the buyer and seller, the transaction quantity, currency and price, involvement of branches, investment and execution decisions within the relevant firm, flags for transactions in shares or sovereign bonds that are short sales and details of any applicable waivers.

A key additional information requirement is the identification of the person or computer algorithm within the investment firm responsible for the investment decision and, separately, for the execution of the transaction. In cases where both a person and an algorithm or more than one person or algorithm is involved, the investment firm should determine on a consistent basis which person or algorithm is primarily responsible and report accordingly.

If a transaction involves a combination of two or more financial instruments the investment firm is required to report the transaction for each financial instrument separately and link those reports by a unique identifier.

ESMA's guidelines emphasise that the transaction report should reflect the capacity in which the firm traded, namely whether it was (i) dealing on own account, (ii) acting as matched principal or (iii) acting in 'any other capacity'.

A required field in the transaction report is the identification of the venue where the transaction was executed. In accordance with ESMA's guidance, a transaction should be considered as executed on a trading venue only when (i) the buying and selling interest of two parties is brought together by the trading venue either on a discretionary or non-discretionary basis or (ii) the buying and selling interest of two parties is not brought together by the trading venue either on a discretionary or non-discretionary basis, but the transaction is nonetheless subject to the rules of that trading venue and is executed in compliance with those rules.

Reporting by branches

Current branch reporting obligations depend on whether the relevant service is being provided by the branch within the member state where it is located. However, there is no harmonised approach to this across member states, which has resulted in some transactions being reported to both the home and host member states and some transactions not being reported at all.

ESMA intends to create a harmonised regime for branch reporting under MiFIR. RTS 22 requires firms to report transactions to the competent authority of their home member state, irrespective of whether a transaction is executed wholly or partly through a branch in another member state, unless otherwise agreed by the relevant competent authorities. The home member state competent authority will then be responsible for routing reports to other relevant competent authorities.

In its initial Discussion Paper, ESMA had proposed that the head office of the branch reports the transaction to the home member state competent authority. Under this model no transaction report would be submitted by the branch to the host member state competent authority. In the subsequent Consultation Paper, ESMA said that it broadly intended to proceed with its suggested approach, but also specifically included activity by branches 'regardless of whether the branches are located inside or outside of the EEA'.

The position in respect of non-EEA branches requires further clarification

However, RTS 22 no longer make any specific reference to branches of a firm outside the EEA. Instead references to home and host member state competent authorities in a number of provisions would seem to indicate that there is no longer an intention to legislate for the reporting by non-EEA branches. For example, recital (15) provides that 'where a transaction is executed wholly or partly through a branch of an investment firm located in another Member State, the report should be submitted only once to the competent authority of the home Member State of the investment firm unless otherwise agreed by the competent authorities of the home and the host Member State'. The position in respect of non-EEA branches therefore requires further clarification.

In accordance with Article 14 of RTS 22, EEA branches of third country firms are required to submit transaction reports to the competent authority that authorised the branch. This does not seem to sit well with the territorial application of MiFIR, which would not appear to apply directly to such firms apart from retail branches that have been required to be established pursuant to Article 39 of MiFID 2 (although equivalent provisions would be likely to apply under national member state regimes in any event).

If the third country firm has branches in more than one member state, the branches must choose jointly which member state competent authority transaction reports will be sent to.

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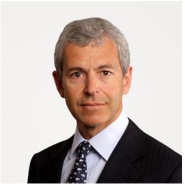

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