Transaction Reporting Under MiFID II

MiFID II will greatly expand the scope of transaction reporting and require asset managers to strengthen their data architecture

New transaction reporting requirements under MiFID II are among the most complex of its reforms. They will require investment firms to implement robust IT solutions to manage the increased data flows or consider turning to third-party solution providers resulting in possible material costs.

Reforms to make buy-side firms accountable

Transaction reporting is a key component of the MiFID framework, allowing regulators to detect and track fraud and other suspected abuses of capital markets. Under the previous MiFID I regime, it has been more a concern for sell-side firms, such as brokers and dealers, who report transactions for their clients. However, under MiFID II, the responsibility has been extended to the counterparties who initiate the transactions, which are typically buy-side firms.[1]

Firms face heavier reporting burden

The scope of transaction reporting has broadened considerably from the MiFID I regime, with an expansion of reportable products, market venues, data fields and reportable transactions. Under MiFID I, mandatory reportable products were limited to equities and some equity exchange traded derivatives, but firms will now have to report on virtually all instruments traded on European Union (EU) venues, including non-EU derivative instruments that relate to an EU security or index.[2] MiFID II will demand transaction reporting on multilateral trading facilities as well as European regulated markets and organized trading facilities. Reportable transactions are currently limited to the purchase and sale of instruments but will be broadened to include the increases and decreases of notional amounts and the exercise of options, warrants or convertibles. There will be 65 data fields to complete, up from the current 24, including more detailed information to identify buyers and sellers and types of trades, such as short selling. Investment firms conducting algorithmic or commodities trading have successfully applied for exemptions in the past but can no longer rely on such leeway under MiFID II.[3] There are some exclusions in the new regime, which include repurchase agreements, stock lending, derivative novations, and the expiration or redemption of instruments resulting from mandatory events that do not involve an investment decision.[4]

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KEY INSIGHTS

- Under MiFID II, the responsibility for transaction reporting will fall to counterparties that initiate transactions
- The new reforms may not eliminate variations in reporting requirements between EU jurisdictions
- Buy-side firms can outsource reporting functions to external investment firms but third party providers are likely to charge a premium for taking on the extra risk

Third country branches impacted

The MiFID II reforms will also impact firms with third country branches, so an understanding of reporting obligations in a geographic context is critical for fund managers. Investment firms in the European Economic Area (EEA) that execute transactions through an EEA

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branch will need to report to their home regulator, unless otherwise agreed by the host and the home Member State. However, an EEA branch for a non-EEA investment firm must report to the regulator that authorized the branch. Where a non-EEA firm has branches in more than one Member State, the branches must decide which single competent authority will receive their transaction reports.[5] Further, for non-EEA firms trading through a market venue in the EEA, the reporting obligation sits at the market venue level for the first EEA intermediary.

The reforms may not entirely eliminate local variations that exist between EU jurisdictions for certain instruments, such as collective investment schemes, so investment firms will need to remain vigilant in complying with local regulations.[6]

They will also need to be careful to avoid duplication. Firms trading in both MiFID and non-MiFID jurisdictions will need to ensure that only MiFID-eligible trades are reported. Regulators have indicated they will have little tolerance for under and over-reporting, so fund managers must implement more systematic tracking of individual branches and affiliates associated with portfolio managers, traders and the desks processing client orders.[7]

Stress on data architecture

The stakes for not properly reporting and recording transactions are high. Under MiFID I, there were a number of highly-publicized fines for firms that failed compliance checks and regulatory scrutiny is unlikely to diminish under MiFID II.[8] In the past, the buy-side could rely on their sell-side counterparties to report trades to regulators but MiFID II will greatly expand the scope and detail required from market venues, brokers and buy-side investment managers. Firms will need to assess their current systems' ability to collect data and review information channels between front, middle and back offices. The increased complexity could prove problematic and firms' IT solutions will need to prepare for and manage the emergence of potential bottlenecking constraints.[9]

MiFID II will require more robust audit trails

While most MiFID I-compliant investment firms have arrangements in place to store transaction records for five years, MiFID II will require more robust audit trails and for firms to possess on-demand documentary retrieval for more complex instruments such as OTC derivatives.[10] Certain firms, such as commodities traders or funds engaged in algorithmic trading that were previously exempt from transaction reporting, will not be able to leverage experience and infrastructure from MiFID I and may be inclined to contract third-party providers to ensure compliance.[11]

Buy-side firms will have the option to transmit reportable transactions to their brokers, if the client is comfortable passing personal data and the broker is qualified to perform the function. There is also the option to outsource to a second investment firm under an Approved Reporting Mechanism (ARM). ARMs will be useful to firms trading with a non-MiFID broker or one outside the EEA, given they streamline reporting obligations and remove the liability of transmitting personal data to a broker.[12] Such arrangements, known as Reception and Transmission of Orders (RTO), shift the regulatory burden but are likely to come at a cost premium. External investment firms that serve that function are likely to demand compensation for taking on the extra risk, which could prove expensive for buy-side firms.[13]

Arranging data solutions to service the new reporting requirements will invariably demand time and resources, but non-compliance could exact a greater cost in terms of investment managers' reputation and their clients' trust.

1. KPMG (2017) MiFID II - Transaction Reporting 2. Ibid. 3. Ernst and Young (2015) Capital Markets Reform - MiFID II 4. Charles River (April 19, 2017) MiFID II Transaction Reporting Challenges for the Buy-side 5. Farrer & Co (Feb. 27, 2017) MiFID II - Transaction Reporting Obligations for Investment Firms 6. Ibid. KPMG (2017) 7. Ibid. Charles River (2017) 8. Thomson Reuters (June 1, 2017) How to Meet MiFID II's Transaction Reporting Rules 9. Finextra (August 21) MiFID II Transparency Puts Stress on Data Architecture 10. Ibid. KPMG (2017) 11. Ibid. Ernst and Young (2015) 12. Ibid. Charles River (2017) 13. Ibid. Ernst and Young (2015)

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