AIMA Webinar:
MiFID II / MiFIR Transaction Reporting and Position Limits

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Introduction

- Reporting requirements dominate implementation discussions (along with rules on payment for research; best ex; taping).
- Limited time remains to test and implement systems ahead of 3 January 2018.
- AIMA has published MiFID2 Guide (February) and vendor list (March).
- Series of AIMA working groups on MiFID2; members encouraged to get involved.
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Overview – Outline

- MiFID II and MiFIR:
  - touch nearly all aspects of the European financial markets, with an emphasis on transparency, market structure, trading, and transaction reporting; and
  - are drafted so as to complement other European financial legislation such as EMIR, MAR and REMIT.
- This presentation focuses on two reporting topics of relevance to managers:
  - the amendments to the transaction reporting regime; and
  - the introduction of an EU-wide position limit and position management regime.

Transaction Reporting - Overview

- Wider application;
  - (1) Branches of third country firms and (2) trading venues (where transactions are executed through their venues by firms not subject to MiFIR) are now captured under MiFID II/MiFIR.
- Additional financial instruments;
  - MiFIR extends the reporting obligation to (1) instruments admitted to a trading venue; (2) instruments where the underlying financial instrument is traded on a trading venue; and (3) instruments where the index or basket of financial instruments is traded on a trading venue.
- Increased number of fields and data required in reports.
  - Annex II to ESMA's December Guidelines increases the transaction report to 65 fields (compared to 25 under existing rules).

Application

The EU/UK transaction reporting regime applies to:

- Investment firms (i.e., MiFID firms);
- Credit institutions providing investment services or performing investment activities (Article 1(2) of MiFIR);
- Branches of third country firms (as per Article 14 of RTS 22);
- Trading venues (where transactions are executed through their venues by firms not subject to MiFIR).
- NB: Strictly speaking, NOT AIFMs or UCITS managers

<u>But note</u>, there are wider implications for third country firms (like those in the US) trading with EU/UK firms subject to the transaction reporting regime. In order to comply with the reporting requirements, the above firms will likely request increased amounts of information from counterparties.

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Obligation and Timing

- Article 26(1) of MiFIR
  - Investment firms which *execute transactions* in financial instruments shall report complete and accurate details of such transactions to the competent authority as quickly as possible, and;
    - *no later than the close of the following working day*.
- Article 26(5) of MiFIR
  - Requires trading venue operators to report details of transactions in financial instruments traded on its platform,
    - *which are executed through its systems by a firm which is not subject to MiFIR.*

Financial Instruments

- Under Article 25 of MiFID, the requirement to report transactions applied to '*any financial instruments admitted to trading on a regulated market*.'
  - Article 26(2) of MiFIR expands the scope of instruments captured to include:
    - financial instruments which are admitted to trading or traded on a trading venue or for which a request for admission to trading has been made;
    - financial instruments where the underlying is a financial instrument traded on a trading venue; and
    - financial instruments where the underlying is an index or a basket composed of financial instruments traded on a trading venue.
- '**Trading venue**' means a regulated market, an MTF or an OTF.

Meaning of ‘transaction’

‘Transaction’ - Article 2 of RTS 22

- the conclusion of an *acquisition* or *disposal* of a financial instrument shall constitute a transaction.
- ‘acquisition’ includes:
  - a purchase of a financial instrument;
  - entering into a derivative contract in a financial instrument;
  - an increase in the notional amount for a derivative contract that is a financial instrument.
- ‘disposal’ includes:
  - sale of a financial instrument;
  - closing out of a derivative contract in a financial instrument;
  - a decrease in the notional amount for a derivative contract that is a financial instrument.
- ‘transaction’ shall also include a simultaneous acquisition and disposal of a financial instrument where there is no change in the ownership of that financial instrument, but post-trade publication is required under Articles 6, 10, 20 or 21 of MiFIR.

Meaning of ‘execution of a transaction’

- ‘Execution of a transaction’ – Article 3 of the draft RTS 22
  - Where an investment firm performs any of the following services or activities that result in a transaction within the meaning of Article 2, it shall have executed that 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;
    - Transfer of financial instruments to or from accounts.
- *Excludes ‘transmitted orders’* transmitted in accordance with Article 4 of the draft RTS 22.

Transmission of Orders

- What about firms that 'transmit' orders?
- Article 26(4) of MiFIR
  - Investment firms which transmit orders shall either:
    - include in the transmission of that order all the details specified in Article 26(1) and (3); or
    - report the transmitted order, provided the transaction report states that it pertains to a transmitted order.
- However note the requirements of Article 4 of RTS 22

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Content of Transaction Reports

MiFID	MiFIR
Article 25(4) of MiFID	**Article 26(3) of MiFIR**
1. Names and numbers of the instruments bought or sold; 2. the quantity; 3. dates and times of execution; and 4. transaction prices and means of identifying the investment firms concerned.	1. Names and numbers of the financial instruments bought or sold; 2. the quantity; 3. the dates and times of execution; 4. the transaction prices; 5. a designation to identify the clients on whose behalf the investment firm has executed that transaction, 6. a designation to identify the persons and the computer algorithms within the investment firm responsible for the investment decision and the execution of the transaction; 7. a designation to identify the applicable waiver under which the trade has taken place; 8. means of identifying the investment firms concerned; 9. a designation to identify a short sale as defined in Article 2(1)(b) of *Regulation (EU) No 236/2012* in respect of any shares and sovereign debt within the scope of Articles 12, 13 and 17 of that Regulation 10. For transactions not carried out on a trading venue, the reports shall include a designation identifying the types of transactions in accordance with the measures to be adopted; 11. For commodity derivatives, reports shall indicate whether the transaction reduces risk in an objectively measurable way;

Transaction Report Fields

- Under the FCA's existing SUP 17 requirements, transaction reports have 25 fields to be provided to the FCA.
- However Annex II to ESMA's December 2015 Guidelines increases the transaction report to 65 fields.

Transaction Report Fields

ESMA data validation fields

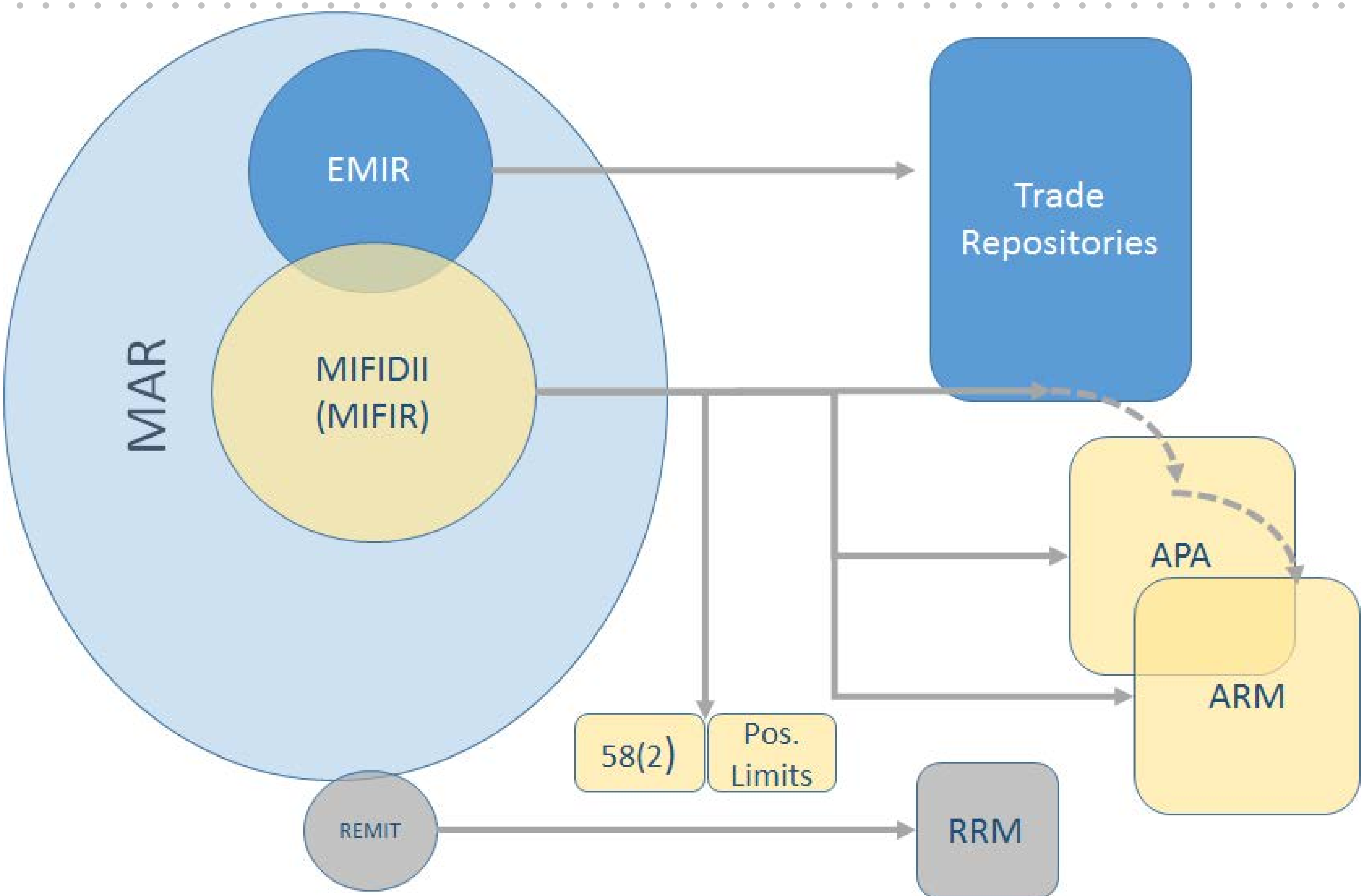
1. Report status
2. Transaction Reference Number
3. Trading venue transaction identification code **(*)**
4. Executing entity identification code
5. Investment Firm covered by Directive 2014/65/EU **(*)**
6. Submitting entity identification code **(*)**
7. Buyer identification code
8. Country of the branch for the buyer **(*)**
9. Buyer - first name(s) **(*)**
10. Buyer - surname(s) **(*)**
11. Buyer - date of birth **(*)**
12. Buyer decision maker code **(*)**
13. Buy decision maker - First Name(s) **(*)**
14. Buy decision maker – Surname(s) **(*)**
15. Buy decision maker - Date of birth **(*)**
16. Seller identification code
17. Country of the branch for the seller **(*)**
18. Seller - first name(s) **(*)**
19. Seller - surname(s) **(*)**
20. Seller - date of birth **(*)**
21. Seller decision maker code **(*)**
22. Sell decision maker - First Name(s) **(*)**
23. Sell decision maker – Surname(s) **(*)**
24. Sell decision maker - Date of birth **(*)**
25. Transmission of order indicator **(*)**
26. Transmitting firm identification code for the buyer **(*)**
27. Transmitting firm identification code for the seller **(*)**
28. Trading date time
29. Trading capacity
30. Quantity
31. Quantity currency
32. Derivative notional increase/decrease **(*)**
33. Price
34. Price Currency
35. Net amount **(*)**
36. Venue
37. Country of the branch membership **(*)**
38. Up-front payment **(*)**
39. Up-front payment currency **(*)**
40. Complex trade component ID **(*)**
41. Instrument identification code
42. Instrument full name
43. Instrument classification
44. Notional currency 1 **(*)**
45. Notional currency 2 **(*)**
46. Price multiplier
47. Underlying instrument code
48. Underlying index name **(*)**
49. Term of the underlying index **(*)**
50. Option type
51. Strike price
52. Strike price currency **(*)**
53. Option exercise style **(*)**
54. Maturity date
55. Expiry date **(*)**
56. Delivery type **(*)**
57. Investment decision within firm **(*)**
58. Country of the branch responsible for the person making the investment decision **(*)**
59. Execution within firm **(*)**
60. Country of the branch supervising the person responsible for the execution **(*)**
61. Waiver indicator **(*)**
62. Short selling indicator **(*)**
63. OTC post-trade indicator **(*)**
64. Commodity derivative indicator **(*)**
65. Securities financing transaction indicator **(*)**

(*) Indicates new fields (or no comparable existing field) introduced under MiFID II, in comparison to the FCA Handbook - SUP 17 – Annex I

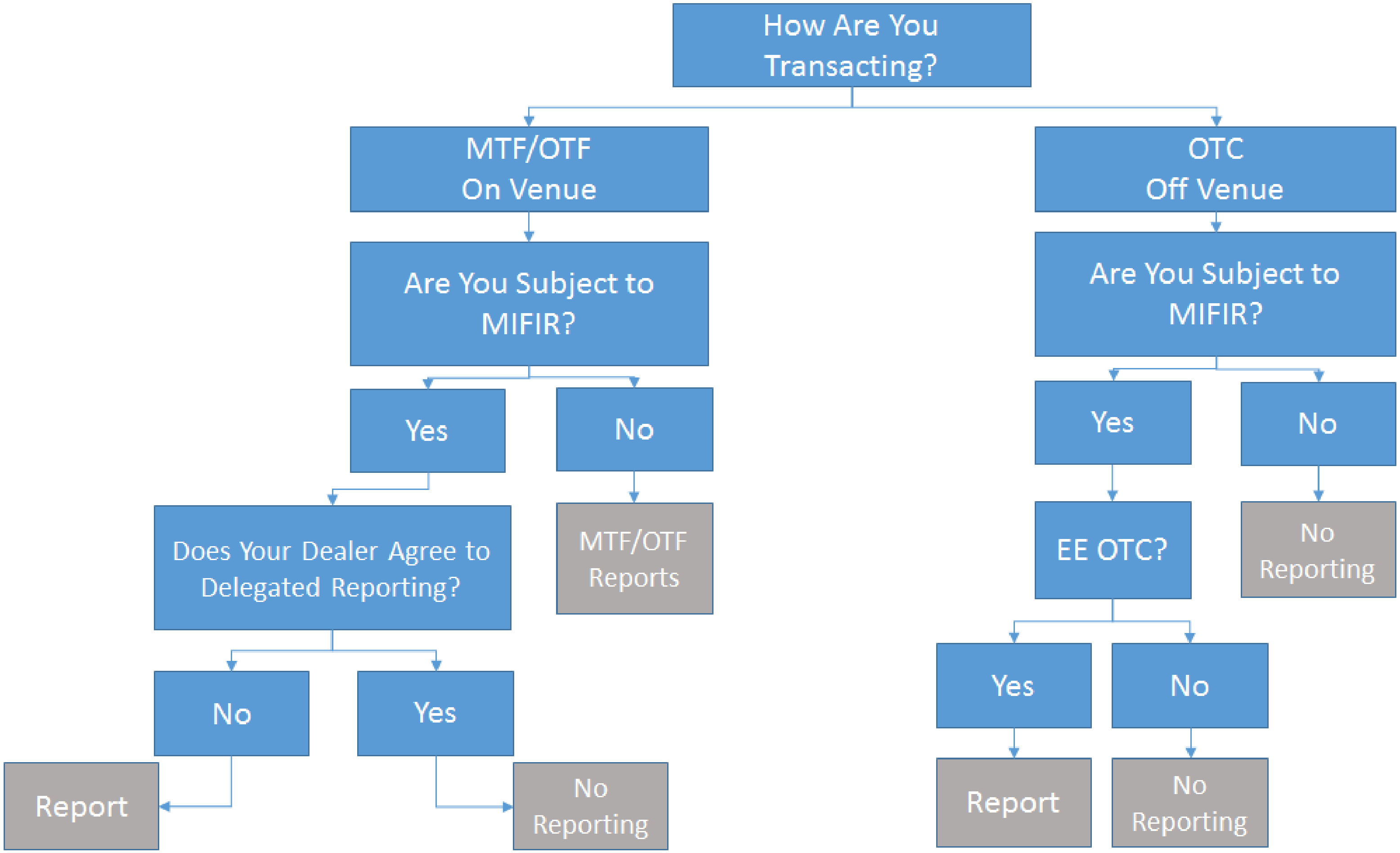
Consequences of Breach

- The FCA uses data provided by transaction reports for market surveillance purposes and to identify potential instances of market abuse and or manipulation.
- Since implementing the transaction reporting regime, the FCA has issued 10+ fines for reporting failures.
- Enforcement notices show firms must not only provide *complete* transaction reports, but also ensure the systems and controls relied on to produce transaction reports are reliable and *accurate*.

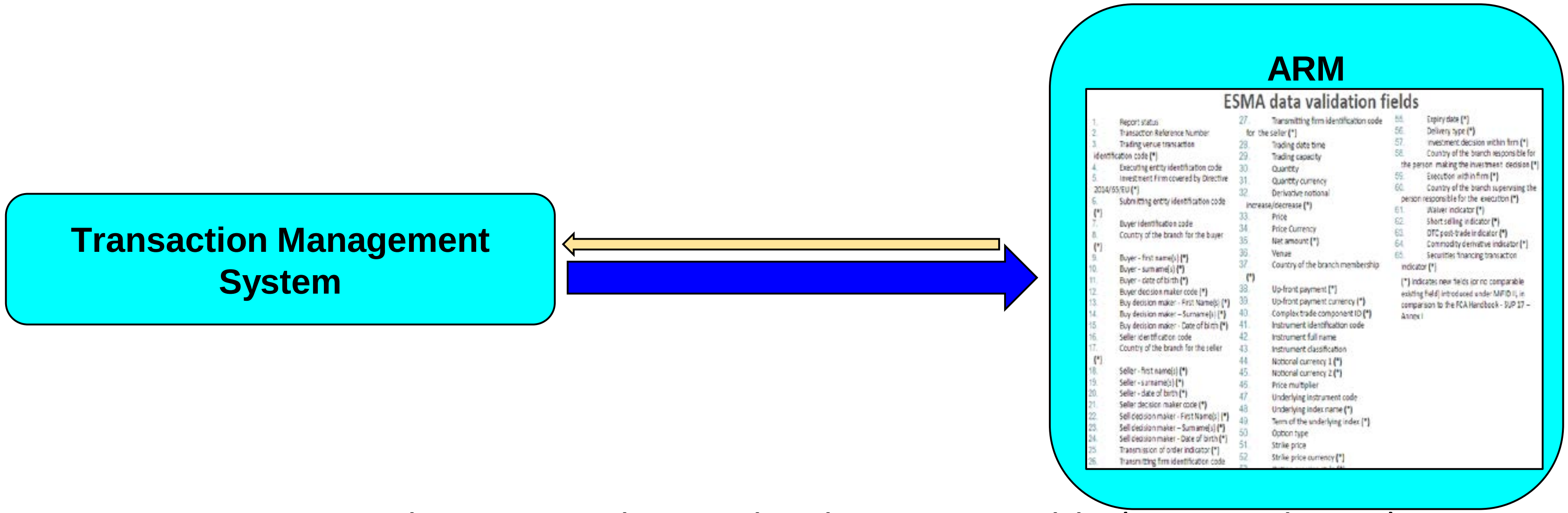
Practicalities | The Big Picture



Practicalities | When Do I Report?



Practicalities | IT Challenges



- Transactions must be sent as close to booking as possible (near real time).
  - Large amount of data validation, mapping, enrichment (always changing).
  - Responsiveness of ARM’s acknowledgement of submitted trades is key to timely reporting.
  - ARMs vary widely in their technological approach to submission and validation.

Practicalities | Inspect What You Expect

- **Double Reporting Risk:** MTF/OTF, Delegated, Internal. The risk of double reporting is very high.
- **Delegated Reporting:** getting data out of house for delegated reporting is challenging/ different. Some brokers are already declining.
- **EEOTCs Are a Natural Surprise Violation**: Closely inspect your portfolio for EEOTCs. Check and double check there are no below radar trades.
- **ARM Madness:** ARMs are in a state of intense flux (commitments, partnerships, alliances, cost).
- **EMIR Repeat**: We are setting up for a last minute onboarding crush like EMIR.
- **What is your backstop?** IT teams regularly underestimate builds. Lots of new vendors offering MiFID solutions. What is your backstop?
- **Reference Data:** There is a lot of new reference data needed.

Position Limits – Overview

- MiFID I
  - To date there has been no comprehensive EU-wide position limit or position management regime.
  - Where such limits have been established they have been applied at the level of individual exchanges.
- MiFID II
  - A new three-pillar framework: (1) position limits; (2) position management; and (3) position reporting.
  - Regime applies to commodity derivatives and economically-equivalent OTC ("**EEOTC**") contracts.
  - Excludes physically-settled gas and electricity forwards covered by REMIT that are traded on OTFs.
  - RTS 21 adopted by European Parliament in February 2017.

Position Limits

- Article 57(1) of MiFID II
  - National regulators will be responsible for establishing and applying position limits on the size of the net position that a person may hold on:
    - commodity derivatives traded on venues; plus
    - commodity derivatives considered the "same" commodity derivatives as such commodity derivatives; plus
    - EEOTC contracts.
  - EEOTC contracts are defined as contracts with "identical contractual specifications and terms and conditions" as exchange-traded contracts.
    - Excludes differences based on different lot sizes, delivery dates that vary less than one calendar day and post-trade risk management.
  - Limits to be set for spot and all non-spot months.
  - Net position calculations do not apply to contracts traded on third-country venues (*e.g.*, a US futures exchange).

Position Limits

- "Commodity Derivatives". The term is defined in Article 2(1)(30) of MiFIR to include:
  - securities based on an underlying commodity;
    - financial instruments referred to in Article 4(1)(44)(c) of MiFID II which relate to a commodity or an underlying referred to in Section C(10) of Annex I to MiFID II
  - cash-settled derivatives;
    - financial instruments referred to in Section C(5) of Annex I to MiFID II
  - physically-settled derivatives other than REMIT products;
    - financial instruments referred to in Section C(6) of Annex I to MiFID II
  - other financial derivatives used as investments; and
    - financial instruments referred to in Section C(7) of Annex I to MiFID II
  - cash-settled derivatives with "exotic" underlyings.
    - financial instruments referred to in Section C(10) of Annex I to MiFID II

Position Limits

- Position limits apply to the net position of a "person" as well as positions held at an "aggregate group level".
  - The scope of the term "person" is unclear, but appears intended to reach through to the end-client.
  - RTS 21 establishes a top-down aggregation rule as follows:
    - net positions must be calculated per subsidiary and at an overall group level;
    - excludes permissible risk-reducing hedges; and
    - calculated for spot and non-spot month limits.
  - In relation to funds, where an investor does not control the fund's trading decisions, the fund's position need not be aggregated with that of the investor.
  - cf. Recital (4) of RTS 21

Position Limits

- Risk-Reducing Hedging Exemption
  - Trades by a non-financial entity that are objectively measurable as reducing risks directly relating to the commercial activities of that entity are not counted towards the limit.
  - Provided the requirements of Article 7 of RTS 21 are met, the following are permissible:
    - macro/portfolio hedging;
    - proxy hedging; and
    - subsequent evolution of risks originally hedged.
  - A non-financial entity must apply to the relevant competent authority for a risk-reducing exemption.

Position Limits

- Procedure
  - ESMA establishes the methodology for national regulators to set limits.
  - National regulators submit proposed limits to ESMA, which has 2 months to issue an opinion.
- Spot Month
  - "Spot month" refers to the contract next to expire; an EEOTC contract is in the spot month when its equivalent contract is in its spot month.
  - Limits to be based on deliverable supply (or, where there is no deliverable supply, on open interest).
  - Baseline set at 25% (or 20% for certain foodstuffs), with scope for national regulators to set a limit from 5% to 35% based on certain factors.
  - Competent authorities calculate deliverable supply.

Position Limits

- <u>Non-Spot Months</u>
  - Refers to the remainder of the contract curve (*i.e.*, not all months).
  - Limits to be based on open interest.
  - Baseline set at 25%, with scope for national regulators to vary the limit up to 35% or down to 5% (or to 2.5% for certain foodstuffs).
- <u>Factors for Raising/Lowering Baseline</u>
  - Maturity
  - Deliverable supply
  - Open interest (ex-correlated instruments)
  - Volatility
  - Number and size of participants
  - Underlying commodity markets
  - New/Illiquid contracts

Position Limits

- <u>Monitoring and Enforcement Authority</u>
  - National regulators have the authority to require persons to liquidate their positions or prevent persons from entering further transactions in contracts.
  - ESMA is responsible for monitoring how national regulators establish and enforce position limits.
  - ESMA is given emergency backstop authority to impose position limits and force position-holders to liquidate their positions or prevent further transactions in contracts where the national regulator is unable or unwilling to do so.

Position Monitoring

- Article 57(8) of MiFID II
  - Requires operators of trading venues (*i.e.*, RMs, MTFs, and OTFs) to apply position management controls including:
    - monitoring the open interest of "persons";
    - access information and documentation from "persons" regarding the size and purpose of a position and cash-market activities;
    - require a "person" to exit or reduce a position; and
    - require a "person" to provide controlled liquidity back into the market.
  - Position management arrangements must be disclosed to the relevant venue's national regulator.

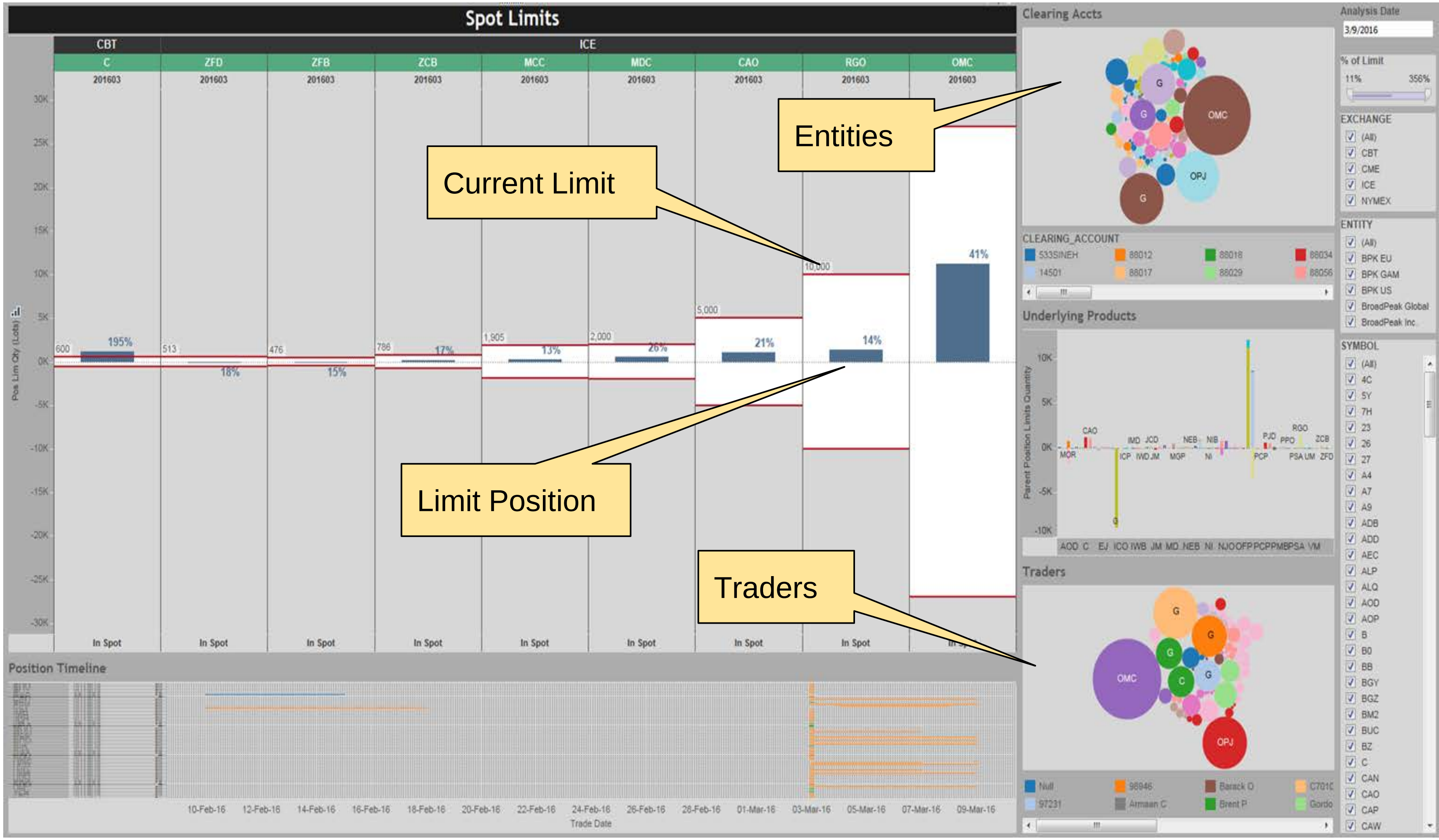
Position Reporting

- Article 58(1) of MiFID II
  - Requires trading venues to publish weekly reports of the aggregate positions held by the following categories of persons for the different commodity derivatives listed on the venue:
    - investment firms or credit institutions;
    - investment funds (AIFs or UCITS);
    - other financial institutions;
    - commercials; and
    - persons subject to EU emissions rules (for emissions contracts).
  - Reports must contain:
    - number of long and short positions per category of person;
    - changes since the previous report;
    - percentage of open interest attributable to each category;
    - number of persons in each category.

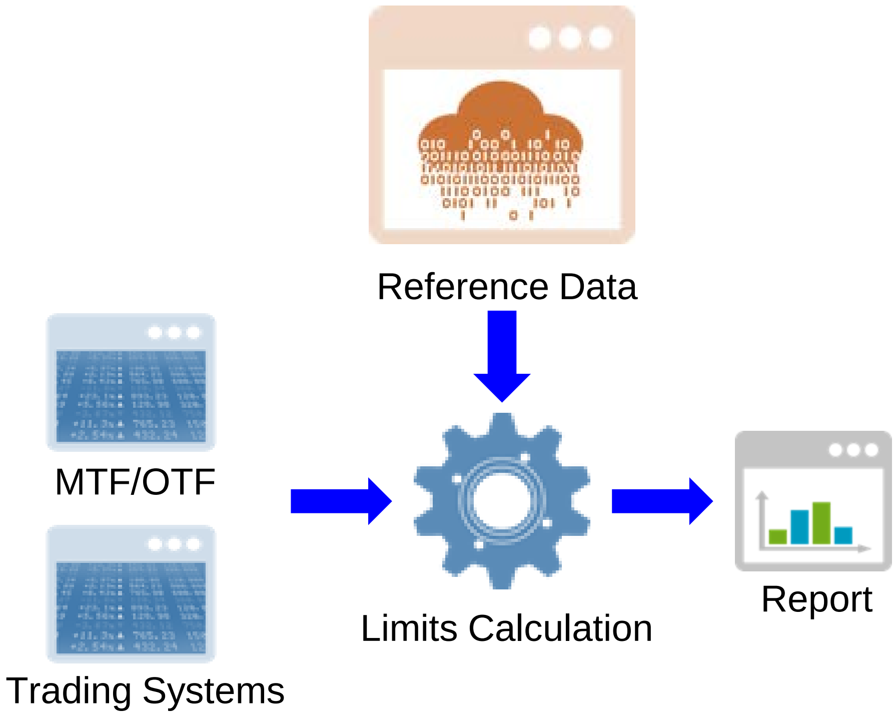
Position Reporting

- Article 58(2) of MiFID II
  - Requires an investment firm that trades commodity derivatives OTC to submit a daily report to either:
    - the national regulator of the trading venue where the commodity derivative(s) are traded; or
    - the national regulator of the trading venue where the most significant volume of such commodity derivative(s) are traded.
  - Reports must contain a "complete breakdown" of:
    - the firm's positions taken in commodity derivatives traded on-exchange and EEOTC contracts; and
    - such positions for the firm's clients, and the clients of those clients "until the end-client is reached".
  - Similar reports to be filed with the relevant trading venue(s).

Practicalities | What Does It Look Like



Practicalities | Challenges



- Connecting systems is a first priority. Must be able to get all trades and grapple with complex positions that impact limits.
- Reference data is challenging. It's far more than just the limits (whch are already complex). Key decisions will have to be made by compliance.
- Calculation engine must be able to follow on and off exchange rules.
- A limits position is not the same as a trading position.

Practicalities | Actions

- <u>Action Items</u>
  - Surveying the organization for all relevant trades and how they are going to get into the limits process.
    - MTF/OTF trades
    - EEOTC trades
    - Extra-EU trading (rules prohibit netting EU/Non-EU positions)
      - Netting This means at any time you may have a both a long and short limit on. Remember a “limits position” is not a “trading position.
  - Outline clear boundaries and segregation for client managed positions. If asked the response has to be unimpeachable.

Questions

Please use the "chat" function on your webinar control panel to ask a question to the moderator or speakers.

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