

# Market Watch

Markets Division: Newsletter on Trade Publication Issues

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## Contents

1. Introduction
2. Background
3. Applying the MiFID trade publication requirements
4. General principles for trade publication
5. Practical examples of trade reporting
  - 5.1 Agency trades
  - 5.2 Principle trades (risk trades)
  - 5.3 Combination agency/principle trades
6. Deferred publication of large transactions

## 1. Introduction

In this edition of Market Watch, we aim to help investment firms in their approach towards implementing the post-trade reporting requirements contained in the Markets in Financial Instruments Directive (MiFID).

In our 2006/07 Business Plan, we indicated that in the first quarter of 2008 we would begin a risk-based review of whether firms affected by MiFID had implemented its requirements appropriately. When we outlined our supervisory priorities, we noted that we would review how the new equity transparency regime was bedding down at the market-wide level.

As part of this workstream, and in ongoing discussions with market participants, we have identified some difficulties and possible inconsistencies in the implementation of MiFID post-trade transparency requirements. In particular, these difficulties relate to trades executed over-the counter (OTC), i.e. outside the rules of a 'regulated market' (RM) or 'multilateral trading facility' (MTF). In some instances, these difficulties and inconsistencies may have led to duplicative publication of trading information, adversely affecting the quality of market data. Following discussion with market participants, it became clear that there was not a 'single' problem but a series of scenarios in which market participants adopted different approaches when publishing OTC trades.

In consultation with a broad range of market participants, including trade associations, we have discussed existing practices and have reached a shared understanding of the appropriate approach to publishing OTC trades.

Although this material does not represent formal FSA guidance, it aligns with our interpretation of how the MiFID post-trade publishing obligations should be applied in several trading situations. Investment firms should consider this information when satisfying themselves that their approach is consistent with the MiFID requirements.

In this article, we use the words ‘publish’ and ‘report’ interchangeably, unless it makes clear that ‘report’ is being used in a different sense. The MiFID regulations generally use the phrase ‘make public’.

In Section 6 of this article, we also clarify several issues relating to the deferred publication of trades.

The information contained in this article complements the previous Market Watch 23<sup>1</sup> from September 2007 on Trade Reporting Issues.

## 2. Background – the main MiFID requirements

The MiFID post-trade transparency obligations are intended to promote the efficiency of the overall price formation process and assist the effective operation of the best execution obligation. To achieve these objectives, the information to be published on recently completed transactions must be both reliable and brought together on a timely and consistent basis.

The obligations apply to all shares<sup>2</sup> admitted to trading on regulated markets. They require RMs and MTFs to publish information on individual transactions executed on their systems, as close to real time as possible. Key features of this information include the date, time, price, volume, and identification of the venue where the trade was executed.<sup>3</sup> Where investment firms conduct off-book trades under the rules of a RM or MTF, the responsibility for publishing details of the trade also lies with the RM/MTF.

The main focus of this Market Watch is the application of the regulations where investment firms execute transactions outside the rules of a RM or an MTF (i.e. bilaterally OTC). In these cases, MiFID requires investment firms to make public the same types of information in trade reports as it requires for transactions concluded using the systems (or under the rules) of RMs/MTFs. These reports too must be published as close to real time as possible.

MiFID and EU regulators, including the FSA, have put in place a number of provisions, described below, that are designed to reduce the scope for the over-reporting of OTC trades.

First, to ensure that information on the same trade is not published by more than one party, MiFID sets out the ways in which the firms participating in the trade should determine which of them is to be responsible for making the required information public. In response to comments we received on Consultation Paper 06/14<sup>4</sup> on the implementation of MiFID, we recognised the importance of clarity about OTC trade reporting responsibilities, stating:

‘...we consider responsibility for this [post-trade reporting] obligation to reside fully with whichever party to the transaction agrees to publish the trade, or where there is no agreement, the party determined by the default list in Article 27(4) of the Implementing Regulation. This means that the non-reporting party has no responsibility for the publication, irrespective of whether the reporting party complies with the MiFID requirements.’<sup>5</sup>

1 Issue 23: [www.fsa.gov.uk/pubs/newsletters/mw\\_newsletter23.pdf](http://www.fsa.gov.uk/pubs/newsletters/mw_newsletter23.pdf)

2 CESR MiFID website, Shares admitted to trading on EU Regulated Markets: [http://mifidatabase.cesr.eu/Index.aspx?sectionlinks\\_id=14&language=0&pageName=MiFIDLiquidSearch](http://mifidatabase.cesr.eu/Index.aspx?sectionlinks_id=14&language=0&pageName=MiFIDLiquidSearch)

3 Trade publication (to the public), the subject of this article, should not be confused with transaction reporting (to competent authorities). Transaction reports, which are submitted to the FSA at the end of each day, include additional information (notably client identifiers) and are confidential reports to the regulator. They assist competent authorities in investigating market abuse such as insider dealing, market manipulation, and breaches of conduct of business rules.

4 FSA Consultation Paper 06/14, *Implementing MiFID for Firms and Markets*.

5 FSA Policy Statement 07/2, *Implementing the Markets in Financial Instruments Directive (MiFID)*, p51.

Second, with the aim of preventing investment firms publishing the same trade more than once (which would increase the likelihood of the same trade being duplicated in any data consolidation process), the Committee of European Securities Regulators (CESR), in its Level 3 work on the publication and consolidation of post-trade information, stated in Guideline No. 2 that:

‘...CESR considers that for the purposes of facilitating the consolidation of transparency data with similar data from other sources, investment firms trading away from an RM or MTF, RMs and MTFs that publish each trade via only one publication channel are in compliance with MiFID provisions.’<sup>6</sup>

In addition, the MiFID Implementing Regulation goes some way to addressing the over-reporting that may arise if firms report multiple legs of what is effectively the same economic transaction. The Regulation requires the parties to take all reasonable steps to ensure that the transaction is made public as a single transaction. For these purposes two matching trades entered at the same time and price should be considered to be a single transaction.<sup>7</sup>

### 3. Market application of the trade publication requirements

In discussions with market participants, we became aware of differences in the understanding of how the post-trade reporting obligations should apply to trading that takes place bilaterally OTC, outside the rules of a RM/MTF. This includes situations where client orders are structured as riskless principal trades, often resulting in an ‘on-market’ market-side trade and a client-side OTC trade.

We understand that duplicate trade reporting may arise in the following situations, in particular:

- where there is a lack of clarity between two principals as to who is to be responsible for a trade report (or whether the trade is to be executed as an off-book trade on an RM/MTF or OTC);
- in riskless principal trades, i.e. with two matching legs; or
- where a client trade comprises multiple market-side trades.

### 4. General principles for trade publication

Following on from previous CESR work on post-trade publication, and in consultation with market participants, we have developed some general principles for trade publication for trading that occurs outside the rules of a RM/MTF.

#### **General principles of trade publication (trades conducted outside the rules of a RM/MTF)**

- To ensure that trade reports provide accurate and useful information to market users, trade reporting should, wherever this is not in conflict with any legal requirement, avoid publishing duplicative trade information.
- Where shares pass from one investor to another via a chain of investment firms, but the movement is economically a single transaction, the ideal outcome should be the publication of a single trade report.
- A chain of trades in which the price changes should continue to be regarded as a single economic transaction provided that any change in price arises solely from rounding.
- Market participants trading bilaterally should always be clear as to which party is taking responsibility for a trade report.
- Trade reporting needs to be predictable – firms need to develop an expectation about where they will report trades and ensure that they are reporting in a consistent manner.

<sup>6</sup> Publication and consolidation of MiFID market transparency data. Level 3 CESR’s guidelines and recommendations for the consistent implementation of the Directive 2004/39/EC and the European Commission’s Regulation No. 1287/2006, February 2007, p6.

<sup>7</sup> See Article 27(4) of MiFID Implementing Regulation and in MAR 7.2.5 of the FSA Handbook.

MiFID states that two matching trades entered at the same time and price with a single party interposed shall be considered to be a single transaction. We do not consider this should preclude a single trade report from being published where a firm has a high level of certainty that the second leg of the trade will be completed at the same price.

## 5. Practical examples of trade reporting

Here, we explain how the trade publication requirements outlined above can be applied to some common examples of trades executed by investment firms. In the following examples:

- the terms ‘investment firm’ and ‘broker’ have been used interchangeably;
- the term ‘agency trade’ is used in a general sense to describe trades where an investment firm buys or sells on behalf of its clients, including where it undertakes those trades on a riskless principal basis; and
- the term ‘principal trade’ applies to trades where an investment trades on own account, either acquiring or disposing of risk (but not as a riskless principal); and
- the term ‘on market’ refers to trades on RMs or MTFs.

### 5.1 Agency trades

In many agency trades, investment firms act on a riskless principal basis, executing a market-side trade and a matching client-side trade. In these cases, the emphasis is on publishing the market-side trade. Where the market-side leg is executed on a RM/MTF, the trading platform publishes that leg of the transaction and the client leg of the trade (between the investment firm and its client) should not be published, whether the client side leg is to be ‘on market’ or OTC.<sup>8</sup>

A similar approach would apply if the market-side leg of the trade takes place outside the rules of a RM/MTF. In Example 1, Broker A fills a client order by trading OTC with Broker B. The brokers should agree who is to publish the market-side of the trade (which will be reported to a trade publication venue). Broker A should not publish the client leg of the trade.

#### Example 1 – Single-fill agency trade OTC

Broker A executes client order of 100 shares OTC on an agency basis (whether or not the trade is structured as a riskless principal type trade):

- Trade: Client ↔ Broker A ↔ Broker B.
- Publication: Brokers agree who publishes market-side trade (Broker A ↔ Broker B).
- Market sees: Total volume of 100 shares.

#### Agency cross

In an OTC agency cross structured as a riskless principal transaction (i.e. where both sides of the trade match and as a consequence, the investment firm faces no market risk) the investment firm performing the cross between two clients should publish only one leg of the trade, as set out in Example 2. Where the selling client has a reporting obligation, the client and broker (performing the agency cross) should agree which party will publish the trade.

<sup>8</sup> If the client-side leg is to be ‘on market’ the market operator may require the member/participant to make a non-publishing trade report.

### Example 2 – Agency cross

Broker crosses Client A order of 100 shares with Client B order. Client A (the selling client) has a trade reporting responsibility which it delegates to the broker.

- Trade: Client A ↔ Broker ↔ Client B.
- Publication: Broker reports Client A leg of trade (Client A ↔ Broker).
- Market sees: Total volume of 100 shares.

If the second leg of the above trade (Broker ↔ Client B) is uncertain and the broker is effectively on risk, this transaction would no longer be an agency cross and would require a second trade report. For example, this might occur when the arranging broker sources shares from Client A in the strong expectation that Client B will buy the shares but has no firm order and is unable to finalise the sale to the second client at the same time as purchasing the shares from the first client.

However, if the broker has a firm order from the second client but is unable to confirm the transaction immediately (for example, because the client is not immediately available) it should still be reasonable to publish only one trade report.

### Multiple-fill agency trades

We understand that market participants would benefit from further clarification of the trade reporting obligations when a firm fills a client order using a number of different sources (a multiple-fill trade). For example, an investment firm may fill a client order from:

- one or more executions on a RM/MTF; and/or
- one or more OTC transactions with one or several third parties.

Where an investment firm fills a client order from a number of different sources, each of the individual trades should be published immediately by the party responsible for publication. This may be the market operator, the firm or a third party broker, depending upon who has responsibility. Where the market-side trades are all executed on RMs/MTFs, those trades are published by the RMs/MTFs on which they were undertaken and the broker should not publish the aggregate client side trade (assuming this reflects the average price of the component trades).

Where some or all the component trades take place OTC, the approach should be similar. Thus, in Example 3, the broker is obliged to ensure that there is publication (whether by itself or others) of any OTC components of the market-side leg of the trade, but, once again, there is no need for the broker to publish the aggregated volume (100 shares) that was achieved on behalf of the client, or the average price at which it was achieved (provided the firm books the order to the client at the average price).

### Example 3 – Multiple-fill agency trade (RM/MTF/OTC)

Broker executes a client order for 100 shares in part OTC and in part on an RM/MTF.

The client order is filled by the broker as follows:

- Broker → RM or MTF trade (80 shares).
- Broker → OTC trade (20 shares).

The appropriate publication approach is:

- RM or MTF publishes 'on market' trade of 80 shares.
- Broker (or other market-side counterparty) reports OTC trade of 20 shares to publication venue.

Market sees: Two trade reports and total volume of 100 shares.

We consider there is no need for an aggregate trade report to be published when the price differs marginally from the average price of the component trades, provided that this difference arises from rounding.

### **Trade passing through chain of firms on an agency/riskless principal basis**

Where a trade passes through a chain of investment firms and the same shares are bought and sold a number of times. We consider, as a general rule, that the trade (e.g. the sale of 100 shares at 100p) should lead to the publication of no more than one trade report, regardless of how many firms are in the chain.

In response to CP 06/14<sup>9</sup>, some market participants asked us to clarify which part of a chain of intermediaries relating to the same end transaction should be published. We responded:

'We consider that where there is a chain of intermediaries relating to the same transaction, only the transaction interacting with an RM, MTF or an investment firm dealing on own account should trigger a post-trade publication. In addressing this point we have had regard to the function of post-trade information (i.e. being primarily for market efficiency and price formation process) and a desire to avoid multiplication of publications and unnecessary publication costs.'<sup>10</sup>

Adoption of this approach in Example 4.1 below would result in two of three intermediaries involved publishing no trade report.

In both examples below, the investment firm in the middle of the chain (e.g. an inter-dealer broker (IDB)) should not publish a trade report, unless it has been delegated trade reporting responsibilities by the Selling Broker. In addition, there is no need for either the Selling Broker or the Buying Broker to publish the client legs of the trade.

#### **Example 4.1 – Chain of investment firms – agency/riskless principal basis**

An order for 100 shares passes through a chain of investment firms where there is no principal risk (i.e. no change in price).

- Trade: Selling Broker → IDB → Buying Broker.
- Publication: Selling Broker reports (SB → IDB).
- Market sees: 1 trade report for 100 shares.

#### **Example 4.2 – Chain of investment firms – agency/riskless principal basis**

An order for 100 shares passes through a chain of investment firms where there is no principal risk (i.e. no change in price).

- Trade: Selling Client → Selling Broker → IDB → Buying Broker → Buying Client.
- Publication: Selling Broker reports (SB → IDB).
- Market sees: One trade report for 100 shares.

<sup>9</sup> FSA Consultation Paper 06/14, *Implementing MiFID for Firms and Markets*.

<sup>10</sup> *Ibid*

The logical and desirable outcome when the same order passes through a number of intermediaries is that a single trade report should be published. To achieve this outcome, intermediaries will need to communicate with their counterparties and be clear about how a particular transaction will be reported.

We recognise that the lengthier a chain, the less likely it is that the shares will pass along the chain at exactly the same price, for instance as a result of one party trading 'on risk' and selling shares at a price which is different to their purchase price. In these cases, at least one additional report may need to be published. However, where firms in the middle of a transaction chain fill a client order from more than one source, they should avoid reporting arrangements that result in the duplicated publication of information.

Our view is that any price change arising from aggregation and rounding should not generate an additional trade report.

## 5.2 Principal trades (risk trades)

When a firm is trading as principal, whether to facilitate client business or on a purely proprietary basis, the objective of avoiding duplicative reporting as far as is possible remains. In respect of a principal trade executed on an RM/MTF, which will be published by the RM/MTF on which the trade was executed, this means that investment firms should not be publishing additional reports.

When a single-fill principal trade is conducted outside the rules of an RM or MTF, there should be a single trade report. In Example 5, where both parties agree that the transaction will be conducted OTC, the obligation is on the seller (Broker A) to report the trade, unless the two parties agree a different arrangement for that trade or have a standing agreement as to who should be responsible for reporting all trades between them. One example of an alternative standing arrangement could be that whenever Broker A deals with Broker B, Broker B will be responsible for publishing the trade report.

### Example 5 – Principal trade executed OTC with another broker

Broker A sells 100 shares on a principal basis OTC to Broker B:

- Trade: Broker A → Broker B (buying).
- Publication: Brokers agree who publishes the trade.
- Market sees: Total volume of 100 shares.

In Example 6, the broker fills a client order from its own book. While this trade itself will be published only once, it is possible that the broker will also enter into other trades to hedge the position it has taken as a result of the client trade. In these circumstances, the market will see reports of both the client trade and the associated hedging trades.

### Example 6 – Single-fill principal trade OTC to fill a client order.

Broker fills a client order of 100 shares from own book (on risk: not as agent, not as riskless principal):

- Trade: Broker → Client (100 shares).
- Publication: Broker reports trade of 100 shares to publication venue.
- Market sees: Report of client trade for 100 shares.

However:

- Trades executed by broker to hedge position (either OTC or on a RM/MTF) are also published by the relevant party.
- Market may therefore see total volume of up to 200 shares associated with the initial trade.

The approach in Example 6 would also apply to all principal trades, including, for example, guaranteed volume weighted average price (VWAP) trades (where the client trade would need to be flagged to indicate that it is determined by factors other than the current market valuation of the share).

### 5.3 Combination agency/principal trades

The following two examples deal with transactions that contain a combination of agency and principal trades. Where an investment firm fills part of a client by trading on own account, there is still no need for an aggregated trade report to be published. Thus, in Example 7 the ‘fill’ from the broker’s own book (20 shares) should be published immediately at the price of execution, and, provided the firm books the order to the client at the average price, there is no need for the firm to publish the aggregated volume (100 shares) or the average price at which it was achieved on behalf of the client.

#### Example 7 – Multiple-fill trade with part risk

Broker executes a client order for 100 shares. Client order is filled by the broker as follows:

- Broker → trade on RM (40 shares).
- Broker → trade on MTF (40 shares).
- Broker from own book → Client (20 shares).

The appropriate publishing approach is:

- RM publishes ‘on market’ trade of 40 shares.
- MTF publishes ‘on market’ trade of 40 shares.
- Broker reports OTC trade of 20 shares to publication venue.

Market sees: Three trade reports and total volume of 100 shares.

However:

- Trades executed by broker to hedge position (either OTC or on a RM/MTF) are also published by the relevant party.
- Market may therefore see total volume of up to 120 shares associated with the initial trade.

In Market Watch 23 on Trade Reporting Issues,<sup>11</sup> we considered a similar situation where an investment firm executes part of a client order against its own proprietary dealing book, allocating tranches of shares to (or from) a client holding account as the order is worked.

To reiterate, our view is that firms passing a specific quantity of risk, at a specified price, from a firm’s dealing book to a client account (or vice versa) is information that should be made public. In other words, an investment firm that fills a client order from its own book should publish those trades immediately (unless subject to any other exemption).

#### Trade through chain of investment firms – principal/risk trades

As noted earlier, as a general rule we consider that where the same trade (e.g. the sale of 100 shares at 100p) passes through a chain of investment firms at the same price this should lead to the publication of no more than one trade report, regardless of how many firms are in the chain.

11 Issue 23: [www.fsa.gov.uk/pubs/newsletters/mw\\_newsletter23.pdf](http://www.fsa.gov.uk/pubs/newsletters/mw_newsletter23.pdf)

Example 8 summarises how a trade that passes through a chain of investment firms should be published when one or more of the intermediaries are on risk.

### **Example 8 – Chain of investment firms – principal risk**

An order for 100 shares passes through a chain of investment firms, including an inter-dealer broker (IDB), where one or more of the intermediaries are on risk:

- Selling Client (SC) → Selling Broker (SB) → IDB → Buying Broker (BB) → Buying Client (BC).

Publishing where either the Selling Broker or the Buying Broker is on risk:

- Selling Broker reports (SB → IDB).
- Selling Broker reports (SC → SB) or Buying Broker reports (BB → BC).

Market sees: Two trade reports, for 200 shares in total.

Publishing where the Selling Broker and the Buying Broker are on risk:

- Selling Broker reports (SB → IDB).
- Selling Broker reports on behalf of Selling Client (SC → SB).
- Buying Broker reports (BB → BC).

Market sees: Three trade reports, for 300 shares in total.

Publishing where the Selling Broker, the Buying Broker, and the IDB are on risk:

- Selling Broker reports (SB → IDB).
- Selling Broker reports on behalf of Selling Client (SC → SB).
- IDB reports/Buying Broker reports by arrangement with IDB (IDB → BB).
- Buying Broker reports (BB → BC).

Market sees: Four trade reports, for 400 shares in total.

We note that changes in the price of a trade resulting solely from rounding should not generate additional trade reports.

## **6. Deferred publication of large transactions**

Transactions that are large enough to satisfy the relevant thresholds in MiFID can qualify for delayed publication (i.e. we do not require them to be published immediately). The size of trade that qualifies for delayed publication and the maximum delays permitted are set out in MAR 7 Annex 1 of the FSA's Handbook. The thresholds depend on the liquidity of the share. To be eligible for a delay, the trade must be between an investment firm dealing on own account and a client of that firm.

### **Large transactions with no principal risk**

The purpose of deferred publication is to protect firms dealing on own account from having to report details of a large client trade before they have had an opportunity to lay off their risk. Therefore, when a firm is not on risk (e.g. agency and riskless principal type trades) we do not think a firm should benefit from a delay, even if the size of the trade exceeds the MiFID thresholds for delayed publication.

### **Example 12 – Large but not on risk trades (above MiFID block size)**

Broker crosses a large buy order from Client A with large sell order from Client B at same price (without taking market risk).

The appropriate approach is that the broker reports the trade with no MiFID delay. Large but not on risk trades should not be delayed.

Similarly, there are circumstances where a firm enters into a trade above MiFID block size, but manages to lay off all of their risk before the end of the applicable MiFID delay. We understand that some market participants have amended their systems to ensure that trades are published immediately after the risk has been laid off, even if this occurs before the end of the applicable MiFID delay. We welcome this initiative by market participants and would encourage others to adopt a similar approach.

### **Guaranteed VWAP trades**

The question of deferred publication is also relevant to situations where an investment firm agrees to fill a large client order (that is large enough to qualify for a delay) at a price that is not available at the time that the order is agreed.

For example, a firm may agree to fill a client order at the volume weighted average price (VWAP), which will not be available until the end of the agreed VWAP period – often the end of that trading day. In some cases, a firm may be unable to fill the whole order by the end of the VWAP period and therefore remain on risk. We understand that there are two approaches to this type of transaction (irrespective of whether the firm still has residual risk):

- The usual approach is to publish a trade report at the end of the VWAP period, with no additional delay.
- A second approach is to add the relevant MiFID delay to the end of the VWAP period.

The rationale for the first approach is that the nature of a principal VWAP trade is that the VWAP period already provides a sufficient time for the firm to hedge its commitment before the size of the order becomes public. In these circumstances, we do not consider that any delay should be added to the end of the VWAP period.

### **Example 13 – Guaranteed VWAP above MiFID block size**

Broker commits to a VWAP trade (above MiFID block size) with client.

The appropriate approach is that the trade is reported at the end of the VWAP period.

## **Contact us**

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