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**CONSULTATION PAPER**

**Transaction Reporting on OTC  
Derivatives and Extension of  
the Scope of Transaction  
Reporting Obligations**

**Deadline for contributions:** CESR invites responses to this consultation paper by **16 August 2010**. All contributions should be submitted online via CESR's website under the heading 'Consultations' at [www.cesr.eu](http://www.cesr.eu). All contributions received will be published following the close of the consultation, unless the respondent requests its submission to be confidential.



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## Executive Summary

This consultation paper sets out CESR's proposal for the possible organisation of transaction reporting on OTC derivatives as well as for the extension of the scope of transaction reporting obligations.

CESR's proposal on transaction reporting on OTC derivatives is based on the assumption that all persons not exempted from European Market Infrastructure Legislation (including MiFID-authorized firms) would have to report their OTC derivatives transactions to trade repositories (TRs) after these will have been established and registered under EMIL.

However, CESR proposes that investment firms would retain the possibility of complying with their transaction reporting obligations with respect to OTC derivatives under MiFID provisions. Investment firms reporting their transactions to a TR, supporting MiFID standards, would be exempted from direct reporting when they communicate to the competent authority their decision to report their transactions through a TR. The MiFID regime would therefore apply to reporting obligations but these could be dealt with by TRs for the account of investment firms in order to avoid duplication. In other words, TRs would be recognised as a valid third-party reporting mechanism under Article 25(5) of MiFID.

As long as EMIL has not been finalised and implemented, OTC derivatives transactions would be reported under MiFID rules, where applicable.

Furthermore, CESR is considering to propose to the European Commission to extend, through a change in Article 25 of MiFID, the scope of transaction reporting obligations to financial instruments that are admitted to trading only on MTFs and to OTC derivatives.

## Background

1. The European Commission (EC) is currently undertaking the review of the Markets in Financial Instruments Directive (MiFID). In order to provide the EC with its advice on the issues under review, CESR is conducting a series of consultations on the various topics covered by the MiFID review. In the area of transaction reporting, CESR already published a consultation paper in April 2010 on its draft technical advice to the EC in the context of the MiFID review in relation to transaction reporting (Ref. CESR/10-292). The final advice prepared on the basis of this consultation will be delivered to the EC by the end of July 2010.
2. Further, in March 2010 CESR received the EC's request for additional information regarding the review of MiFID<sup>1</sup>. This request included some specific questions on transaction and position reporting, some of which CESR addresses in this consultation paper (CP). The deadline for responses to this CP is 16 August 2010.

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<sup>1</sup> <http://www.cesr.eu/popup2.php?id=6574>

## **1. Possible ways to organise transaction and position reporting on OTC derivatives**

3. On 14 June 2010, the EC initiated a public consultation on Derivatives and Market Infrastructures, in order to collect views on mandatory clearing of OTC derivatives, on requirements for and interoperability of central counterparties and on requirements for trade repositories. Responses to this consultation will help the EC finalise its legislative proposal to regulate the clearing of OTC derivatives and to introduce some sort of obligation to report OTC derivatives trades to trade repositories (TRs). The reporting requirements to be introduced by the future European Market Infrastructure Legislation (EMIL) is also linked to the MiFID transaction reporting obligations.
4. In this context, the EC has asked for CESR's views on how best to arrange the flow of information to be provided by investment firms to regulators for transaction and position reporting purposes. CESR was particularly requested to consider the objective of minimising any double reporting for investment firms. This section of the consultation paper analyses pros and cons of the different options for ensuring the availability of this information that have been identified.

### **Differences between transaction and position reporting**

5. Transaction reporting obligations provide for reporting of individual transactions on specific financial instruments. Position reporting, on the other hand, aims at providing information on the economic exposure of an investor or counterparty to a specific derivative instrument, an underlying instrument, an underlying issuer of financial instruments and/or a counterparty at a specific moment of time (date).
6. There are several differences between transactions in OTC derivatives and the resulting positions that may merit different solutions for the purpose of reporting to regulators.
7. Transaction reporting is a “flow variable”, while position reporting is a “stock variable”. Reporting transactions to regulators for the purpose of market abuse detection has to be a daily flow of information and delays must be avoided at all costs. Position reporting can be considered with a frequency lower than daily (e.g. weekly, monthly) plus on an ad hoc basis (at the request of a supervisor, when analysing a particular case relating to the underlying security or to a specific participant) depending on the uses that have been envisaged.
8. Transaction reporting for market abuse surveillance purposes has been identified as a need by regulators well before the financial markets crisis started. Transactions in OTC derivatives are already reported in some EU Member States (at least UK, Spain and Ireland), where this information plays a fundamental role in market monitoring. Many other Member States have plans to introduce transaction reporting on OTC derivatives in the short term (coming months) under recital 45 of MiFID. However, the development of a regulatory position reporting to monitor systemic risk and improve prudential supervision has been a clear consequence of the crisis. The calendar for the adoption of such a regime will be subject to the adoption and implementation of EMIL. Furthermore, there is also a non legislative initiative that is sponsoring the creation of TRs in the context of the commitments of some ISDA dealers. This project is clearly aligned with the purpose of EMIL and highly valuable at the moment, but its current progress and scope is not as developed as MiFID transaction reporting for market abuse surveillance purposes.
9. CESR is currently elaborating on a regulatory proposal regarding transaction reporting of OTC derivatives as an extension of the MiFID regime (see section 2 of this CP), but the work on position reporting is still ongoing.
10. Transaction reporting has been of interest mainly for securities regulators, namely for supervision of conduct of business rules and, in particular, market abuse. Position reporting, on the contrary, has so far been mainly an objective for prudential/systemic supervision (both insurance and banking supervision), especially to detect concentration of systemic risk and prevent possible complications. Position reporting may become of increased interest for securities regulators (e.g. in the context of the introduction of measures to ban and/or disclose short selling



transactions or to monitor open interest positions in one specific underlying instrument or issuer), and transaction reporting for prudential regulators; however, the two data flows are likely to remain complementary to one another, with differences and overlaps. In addition, the expected level of detail of the data (granularity) may be different for prudential and securities regulators.

11. Currently, the information gathered and stored by existing TRs is different from the information necessary for supervision of compliance with MiFID and MAD provisions. Although no details are final yet, it is probable that TRs will host in the future information on foreign underlying instruments that are not admitted to trading on EU regulated markets (i.e. an equity swap position on IBM shares or a CDS transaction on US government bonds), as well as categories of derivatives that are of less interest for securities regulators (interest rate or currency derivatives). Besides this, some information that is essential to calculate positions accurately (e.g. exercises of options) has to be sent to TRs is of little or no use for market surveillance and does not need to be included in transaction reporting.
12. In addition, the scope of application of MiFID and EMIL will probably be different. MiFID provisions apply solely to financial intermediaries (investment firms) that are the only ones authorised to arrange transactions on OTC derivatives on a professional basis, according to MiFID. EMIL, on the contrary, may end up having a more ample scope, engulfing positions held not only by intermediaries but also by investors (hedge funds, insurance companies), for obvious reasons linked to prudential supervision.

### **Overarching principles**

13. Any regime for position and transaction reporting of OTC derivatives should be guided by some basic principles:
  - a. Unconditional and quick access to data should be guaranteed to the regulators wherever the TRs are located
  - b. Information received by regulators should be in a specific unified format, to be defined pursuant to the provisions of MiFID/EMIL
  - c. Data quality should be paramount, since it impacts the quality and accuracy of supervision
  - d. Duplication of reporting obligations for firms or investors should be avoided
  - e. Extending transaction reporting to OTC derivatives is urgent and the work to achieve that is much more advanced than the work on position reporting.
14. In any case, with respect to the second principle, it is assumed that fields and specifications to report transactions (or positions) in OTC derivatives will be pre-defined, based on the work done so far by CESR (and in the future by CEBS/CEIOPS). Therefore, the data that competent authorities will receive will be harmonised and exactly the same no matter what option is chosen (as described below).
15. In order to meet the above overarching principles, CESR has identified two possible options.

#### **Option 1: Establish a single reporting regime for both transaction and position reporting on OTC derivatives, based on reporting through trade repositories.**

16. In this option, both regulated entities and investors subject to EMIL would report transactions and initial positions in OTC derivatives to TRs, which would then calculate the positions based on the subsequent regular transaction data flow and other information (early termination, exercises, etc.). TRs would then report positions periodically to relevant regulators (probably prudential ones) and transactions daily to securities regulators. This system, when enacted, would substitute and abolish the MiFID reporting regime for OTC derivatives (but not for the other types of financial instruments).

**Pros:**

- a. Simplicity of establishing a single reporting rule and a single reporting channel for both types of data.
- b. No duplication of reporting would occur, since regulated entities and investors would report once to a single point.
- c. Using the same technical protocols and standards fixed by the TRs, firms could comply with MiFID and EMIL requirements.
- d. This reporting regime could increase the quality of data (especially if the reporting channels would be centralised/supervised entities like TRs) and minimise the problems for competent authorities to verify the coherence of the flow of information reported.
- e. The use of TRs as the channel to store OTC derivatives information seems to have a higher degree of global coverage. In fact, if some coordination with other third country authorities is sought, the TR channel should have to be considered in any way.

**Cons:**

- a. The same regime would apply to two types of information that are being generated by different subjects (investment firms vs. investors), have different nature (flow vs. stock) different supervisory purposes (market abuse vs. prudential supervision), different calendars (MiFID vs. EMIL), different scopes (EU underlying instruments vs. all instruments) and different periodicity (daily vs. less frequent reporting).
  - b. Multiplication of the possible reporting channels by each investment firm (a particular firm could be, for instance, reporting transactions in shares through a regulated market, in bonds directly to the competent authority and in OTC derivatives through the trade repository).
  - c. Potential risk that the market power of TRs (that come close to natural monopolies) would be misused to the detriment of firms and investors obliged to report through them.
  - d. OTC transaction reporting is an urgent need for market abuse supervision in many countries and is scheduled to start by the end of 2010; hence, in the opinion of CESR, it cannot wait for the transposition of EMIL, the establishment and authorisation of TRs and the definition of new reporting standards and formats.
17. Because of the disadvantages of the possible option 1 in general and the advanced work on transaction reporting of OTC derivatives through the existing transaction reporting exchange mechanism (TREM) under MiFID in particular, CESR does not favour this option as a possible solution for transaction and position reporting on OTC derivatives.

**Option 2: Define a new position reporting regime through trade repositories and allow MiFID transaction reporting through trade repositories**

18. This option is based on the assumption that all persons not exempted from EMIL (including MiFID-authorized firms) would have to report transactions on OTC derivatives to TRs after these will have been established, registered (or recognised for those not located in the EU) and their regulatory regime defined.
19. However, it is proposed that investment firms would retain the possibility of complying with their transaction reporting obligations with respect to OTC derivatives under MiFID provisions. This implies that transaction reports would be sent directly to the relevant competent authorities, together with all the other transaction reports provided following MiFID requirements.
20. Investment firms reporting their transactions to a TR, supporting MiFID standards, would be exempted from direct reporting *ab initio* (not case by case) when they communicate to the competent authority their decision to report their OTC derivatives transactions through a TR. Therefore, the MiFID regime would apply to reporting obligations but these could be dealt with by TRs for the account of investment firms in order to avoid duplication.



21. Concisely, as long as EMIL has not been finalised and implemented, OTC derivatives transactions would be reported under MiFID rules, where applicable. When EMIL comes into force and TRs have been registered and start to operate, these transactions could be reported through TRs to relevant competent authorities, but complying with MiFID obligations. In other words, TRs would be recognised as a valid third-party reporting mechanism under Article 25(5) of MiFID.
22. With regards to position reporting, it would be conducted (where applicable) through TRs under the EMIL regime both to banking, insurance and securities regulators, in a common format. CESR is not in a position to specify the characteristics of such a position reporting regime at this stage, since it does not hinge on MiFID provisions.
23. As an alternative, since more and more categories of OTC derivatives could become eligible for mandatory clearing (like CDS), it might also be possible to utilise central counterparties (CCPs) as a reporting channel on behalf of firms, provided that the data would be in a format suitable for transaction reporting purposes.

**Pros:**

- a. This option would be compatible with existing systems and would not impede the immediate extension of the MiFID regime to OTC derivatives. CESR members could continue working on transaction reporting of OTC derivatives irrespective of when EMIL comes into force.
  - b. No double reporting obligations would be created.
  - c. Investment firms could comply with MiFID provisions to report transactions by relying on TRs (and/or CCPs).
  - d. Information from TRs could be distributed and shared through TREM, seamlessly (same files, timing and rules, system operated by ESMA) with all other transaction reporting information, allowing easy integration in market surveillance systems.
  - e. This option would require minimum implementation work or no work at all if the exemption of direct reporting when using the TRs would be enshrined into the MiFID Implementing Regulation.
24. In all likelihood, if the TRs' system for transaction and position reporting on OTC derivatives proved to be more efficient, most - if not all - of the transaction flow would come in the future through TRs.
25. This option (option 2) is the one favoured by CESR.

**Question 1**

**Do you agree with the solution proposed by CESR for the organisation of transaction and position reporting on OTC derivatives?**

**Question 2**

**Do you have any other views on the possible ways to organise transaction and position reporting on OTC derivatives?**

**2. Extension of the scope of transaction reporting obligations**

26. Recital 45 of MiFID provides discretion for Member States to apply transaction reporting obligations enshrined in Article 25(3) to financial instruments that are not admitted to trading on a regulated market. There are two clear extensions that some Member States have adopted or are considering on the basis of the experience after MiFID came into effect: 1) extending reporting obligations to transactions in financial instruments admitted to trading only on MTFs (not on regulated markets) and 2) extending reporting obligations to transactions on certain OTC derivatives.





27. There are several reasons for engulfing financial instruments admitted to trading only on MTFs within the transaction reporting obligations. According to Recital 6 of MiFID, definitions of regulated markets and MTFs should be introduced and closely aligned with each other to reflect the fact that they represent the same organised trading functionality.
28. Regarding the Market Abuse Directive (MAD), the European Commission is currently consulting<sup>2</sup> on extending the scope of MAD to cover instruments which are admitted to trading and/or traded on an MTF but not traded on a regulated market. Since the MiFID transaction reporting regime is one of the main supervisory tools for market abuse purposes, it is therefore essential for this regime to cover all transactions that could potentially constitute market abuse, including the ones on instruments admitted to trading only on MTFs and not only shares, but also other financial instruments like bonds and eventually derivatives.
29. Transparency mechanisms, financial product innovations and the general impact of events in globalised markets and platforms all call for the need of competent authorities to have regular information about the trades on securities negotiated only on MTFs. If MTFs develop (some are doing so already now) their role as alternative markets for different types of issuers (mid and small caps, for instance), this would also be a good reason to introduce transaction reporting requirements for transactions made in financial instruments admitted to trading only on these trading venues.
30. Therefore, a common effort has to be done in order to ensure the capability of competent authorities to have information on instruments admitted to trading only on an MTF and to have the appropriate tools to correctly apply policies to prevent market abuse. CESR considers that this should be done through MiFID, and not by extending nationally the obligations on the basis of recital 45 of MiFID.
31. On the matter of OTC derivatives, in order to enhance competent authorities' ability to detect suspicious activity and maintain the integrity of their markets, CESR members have decided to exchange transaction reports on some OTC derivatives. CESR is currently working on harmonising the technical standards on the collection and exchange of transaction reports to include OTC instruments whose value is derived from instruments admitted to trading on a regulated market. The relevant consultation paper (Ref. CESR/09-768) and feedback statement to it (Ref. CESR/09-987) can be found on the CESR web site.
32. Recent events in financial markets have shown the clear need of having information about trades on OTC derivatives, both for market surveillance and investor protection purposes.
33. Financial derivative products typically traded OTC, like CDS, OTC options or total return swaps, have proved to play a very important role in recent market situations where strong volatility movements have finally affected all sectors, countries and types of investments.
34. Moreover, competent authorities have noted that, due to financial product innovations, there is a range of OTC financial instruments that mirror instruments admitted to trading on regulated markets than can affect prices on regulated markets and MTFs and that can equally be used for the purpose of market abuse, which are now out of the scope of the transaction reporting exchange mechanism.
35. As long as OTC financial instruments can mirror products traded on regulated markets, the price and volatility relationship between them is direct and unavoidable, and has to be considered when conducting market abuse investigations. Some OTC products have reached such a high degree of popularity and trading activity that they can perfectly influence (not only follow) the price evolution of the traded underlying they are related to.
36. Transaction reporting of OTC derivatives would meet the requirements expressed by G20<sup>3</sup> for improve the regulation, functioning and transparency of financial and commodity markets to address excessive price volatility.

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<sup>2</sup> [http://ec.europa.eu/internal\\_market/consultations/2010/mad\\_en.htm](http://ec.europa.eu/internal_market/consultations/2010/mad_en.htm)

<sup>3</sup> [http://www.g20.org/Documents/pittsburgh\\_progress\\_report\\_250909.pdf](http://www.g20.org/Documents/pittsburgh_progress_report_250909.pdf)





37. It is also true that the increasing importance and size of OTC markets makes fully understandable that the competent authorities need to have information about the trades in OTC derivatives. According to recent BIS statistics<sup>4</sup>, total notional amounts outstanding of OTC derivatives reached \$615 trillion by the end of December 2009, which means a 12% increase compared to December 2008 data.
38. Competent authorities need to enhance their ability to detect suspicious activities and to maintain the integrity of their markets, and those objectives can only be achieved by collecting and exchanging specific information about trades executed on both regulated markets and OTC.
39. Some regulators are already collecting information about trades on OTC derivatives whose underlyings are instruments admitted to trading on regulated markets. According to the feedback received from those regulators, this has been a very useful tool to improve their market surveillance activities and to monitor possible market abuse situations.
40. Since the main reason for the extension of the reporting obligations is the possibility to use an OTC derivative as a substitute to a “traditional” security, the basic criteria to define the scope of the extension would be whether the value of the OTC derivative depends on the performance of a financial instrument that is admitted to trading on a regulated market or on the credit risk of a single issuer of such financial instruments. Therefore, credit derivatives on baskets or indexes, with no exposure to an individual issuer in particular, would be excluded from the reporting regime.

### **Proposal**

41. CESR is considering to propose to the European Commission to extend, through a change in Article 25 of MiFID, the scope of transaction reporting obligations to financial instruments that are admitted to trading only on MTFs and to OTC derivatives. In the latter case, CESR recommends that the exact scope of the instruments would not be exhaustively set out in the Level 1 text but could be expanded through Level 2 measures or ESMA technical standards<sup>5</sup>. This seems necessary in order to ensure that the scope of the reporting obligation can be more easily adjusted to respond to the new innovations in the market.
42. Recital 45 of MiFID could be retained in order to have the ability to require data at national level on other financial instruments that may become widespread in the future and that would need to be included in the transaction reporting regime, but not on an EU wide basis.

### **Question 3**

**Do you agree with the extension of the scope of transaction reporting obligations to the identified instruments?**

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<sup>4</sup> Source: *OTC derivatives market activity in the second half of 2009*, Monetary and Economic Department, May 2010, [www.bis.org](http://www.bis.org)

<sup>5</sup> The OTC derivatives subject to the reporting obligations could at least include those covered in CESR’s feedback statement on the consultation on “Classification and identification of OTC derivative instruments for the purpose of the exchange of transaction reports among CESR Members” (CESR/09-987).