

## *Client Bulletin - Financial Services*

### *Transaction Reporting by Investment Managers*

The FSA has announced the end of its period of “regulatory forbearance” in relation to compliance with the UK transaction reporting requirements.

Prior to the implementation of the FSA’s amended transaction reporting requirements on 1 November 2007 there was a considerable amount of debate as to the application of those requirements to investment managers. In the light of the debate and uncertainty, the Financial Services Authority (“FSA”) recognised that firms would not be in a position to comply from 1 November and so indicated that there would be a period of “regulatory forbearance”.

Although the debate has continued and some uncertainty still remains, the FSA has now indicated this period of regulatory forbearance will come to an end at the end of this month (April 2008). However unsatisfactory the position may be for investment management firms, they now have no alternative but to ensure full compliance with the rules. So, what are the requirements?

#### **What is transaction reporting?**

Transaction reports are made by a firm to its regulator to enable the regulator to monitor markets. They must not be confused with the separate obligations some firms may have to report transactions to trading platforms or to undertake post-transaction trade reporting.

The requirements are set out in SUP 17 of the FSA’s Handbook.

#### **When does the obligation arise?**

The obligation to make a transaction report will apply to an investment manager whenever it “executes a transaction” in a relevant financial instrument.

#### **What is a “transaction”?**

A “transaction” for these purposes is the purchase or sale of a relevant financial instrument (see below). It does not include securities financing transactions (repos, stock lending, margin lending), the exercise of options or covered warrants, or primary market transactions (such as issuance, allotment or subscription) in shares, depositary receipts in respect of shares, bonds and securitised debt. Certain movements across the accounts of a single legal entity and some rolling spread bets are also outside the scope of the regime.

#### **When does an investment manager “execute” a transaction?**

The FSA takes the view that an investment manager will execute a transaction when it has made a decision to deal and enters into a transaction in an agency or principal capacity. So, where the investment manager itself executes the transaction or submits instructions to a broker for execution it will be executing the transaction for the purposes of the transaction reporting rules and, subject to the exceptions outlined in the remainder of this note, it will have the obligation to report.

Firms whose sole activities are to advise and arrange transactions on behalf of clients (without power to take discretionary investment decisions or deal as agent) will not be caught by the transaction reporting requirements.

#### **What financial instruments are subject to the reporting obligation?**

Transactions in the following instruments are reportable:

- a financial instrument which is admitted to trading on an EU regulated market or a UK prescribed market (such as AIM) - this encompasses a wide range of investments (shares, debt instruments, money-market instruments, units in collective investment undertakings and derivatives) that are admitted to trading on such a market, whether or not the transaction in question is actually carried out on that market; and
- an OTC derivative the value of which is derived from, or otherwise dependent upon, an equity or debt-related financial instrument which is admitted to trading on an EU regulated market or on a UK prescribed market.

It is proposed that in the second half of 2008 (following a consultation process) derivatives that are admitted to trading on non-EU exchanges whose value is derived from, or otherwise dependent upon, a single equity or single debt instrument admitted to trading on a UK regulated or prescribed market will also become reportable.

Many financial instruments admitted to trading on EU regulated markets and UK prescribed markets are also traded on markets outside the EU (e.g. they are dual-listed) and any transaction in such instruments will therefore be reportable under the FSA rules (even if the transaction takes place on the non-EU market).

### **When can an investment manager rely on someone else to make the transaction report?**

There are three sets of circumstances in which an investment manager can rely on another person to make the report.

#### **1. Reliance on approved reporting mechanisms, regulated markets or MTFs**

An investment manager is not required to make a transaction report if (i) a report is made directly to the FSA by an approved reporting mechanism or by an EU regulated market or MTF (multilateral trading facility) through whose systems the transaction was completed and (ii) the investment manager has taken reasonable steps to verify that the reports will be made in accordance with the FSA's requirements. (The FSA sets out in SUP 17.2.4 specific matters in respect of which a firm should satisfy itself. These include the existence of contractual arrangements providing for the reports to be made.) An "approved reporting mechanism" is a trade-matching or reporting system that has been approved for this purpose by the FSA.

#### **2. Reliance on third party agents**

An investment manager may rely on a third party appointed to act on the firm's behalf to make a transaction report to the FSA.

#### **3. Reliance on third parties - brokers - the SUP 17.2.2G exemption**

An investment manager may rely on a third party (such as its broker) to make transaction reports to the FSA provided that:

- the manager is exercising its discretionary investment management powers or has specifically recommended the transaction to its client; and
- the manager has reasonable grounds to be satisfied that the other person will make a transaction report to the FSA (or other relevant authority) which will include such information as the firm would have been obliged to provide (other than the identity of the firm's client).

The FSA has indicated that "reasonable grounds" could include checking - at the outset and thereafter at least once a year - that a firm on which the manager is proposing to rely is still an investment firm that is required to transaction report. Where a broker reports to the FSA under the circumstances envisaged by SUP 17.2.2G it only needs to identify the investment manager and does not need to identify the manager's underlying clients. Bulk trades on behalf of the investment manager can therefore be reported without also reporting the individual allocations to each underlying investment management client.

### **So, can an investment manager always rely on a broker to transaction report?**

**No** - unfortunately not. While the provisions relating to reliance on brokers may appear broad, unless the broker has contracted to make the reports on behalf of the manager under paragraph 2 above, in practice there will be many circumstances in which such reliance will not be possible. Therefore the investment manager will have the reporting obligation. Some significant examples are set out below:

**Situations where a UK investment manager will NOT be able to rely on a broker to transaction report for it under SUP 17.2.2G include:**

- where the broker does not itself “execute” the transaction (i.e., it does not enter into the transaction as principal or as agent, but instead merely passes the order to another person for execution), such as where an EU broker passes an order to a non-EU office for execution;
- where the broker is a non-EU broker;
- where the broker is a non-UK EU broker but the transaction relates to an instrument which he is not obliged to report. This is likely to arise in two key instances where the FSA rule requirements go beyond the MiFID requirements, i.e.:
  - the transaction involves instruments admitted to trading on a UK prescribed market (such as AIM) but not on an EU regulated market; or
  - the transaction involves OTC derivatives the value of which is linked to or derived from an equity or debt instrument (or an equity or debt-related index) which is admitted to trading on an EU regulated market or a UK prescribed market.
- where the broker is an EU broker in a jurisdiction which has not yet implemented MiFID it is unlikely that reliance could be placed on such a broker until such time as it is subject to MiFID requirements (unless a specific contractual reporting obligation is accepted by it);
- where no broker is used, for example, internal crosses between different client accounts or transactions agreed direct between one investment manager and another;
- where the investment manager is not acting in the course of discretionary management activity on behalf of one or more clients or following a specific recommendation made by it to its client (e.g. an execution-only trade on behalf of another member of its group).

**How should reports be made?**

All reports must be in electronic form, except in “exceptional circumstances” (see SUP 17.3.1R). A list of the approved reporting mechanisms is available on the FSA website. They include the FSA’s web-based transaction reporting system. Reports should contain the minimum information set out in SUP 17 Annex 1.

**By when must a transaction report be made?**

The obligation is to make a transaction report to the FSA as quickly as possible and by not later than the close of the working day following the day upon which the transaction took place. Note that a report is made when it is received by the FSA, not when it is delivered to a reporting channel.

**What are the record keeping requirements?**

The firm must maintain all relevant data relating to all transactions in financial instruments that it has carried out, whether for its own account or on behalf of a client, for at least five years. That information must be kept in such a form that it can readily be gathered and transmitted to the FSA, should it request it.

If you would like further advice on this issue, please contact Jane Tuckley in the Financial Services and Markets Department.

**Travers Smith**

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10 Snow Hill  
London EC1A 2AL  
T +44 (0)20 7295 3000  
F +44 (0)20 7295 3500

[jane.tuckley@traverssmith.com](mailto:jane.tuckley@traverssmith.com)