

# Making a success of Securities Financing Transactions Regulation

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## ABSTRACT

*This time next year, firms should find themselves progressing well through their Securities Financing Transactions Regulation (SFTR) transaction reporting projects and gearing up to start sending the first records to trade repositories (TRs) across Europe. As with over-the-counter (OTC) derivatives before, transaction reporting is a new endeavour in the securities financing and repo world, with new terminology, new workflows and, inevitably, new concerns arising as the reporting start date approaches. REGIS-TR is one of the largest TRs under the European Market Infrastructure Regulation (EMIR), and a future TR for SFTR (pending authorisation from the European Securities and Markets Authority (ESMA) once the service extension application process opens later in 2018), and this paper uncovers some of the high level aspects of SFTR reporting and answers some of the questions being asked about the new regime. Most importantly, the paper takes a look at*

*how firms can make a success of SFTR and avoid a knock on the door from their regulator.*

**Keywords:** SFTR, reporting, UTI, delegation, ESMA, reconciliation, EMIR

## DATA SUBMISSION AND VALIDATION

The first step towards successful reporting is for firms to ensure their trading data is reported to their trade repository (TR), on time and fully complete. For Securities Financing Transactions Regulation (SFTR), data can only be submitted to the TRs in ISO 20022 XML format; unlike the European Market Infrastructure Regulation (EMIR), no CSV or Excel files will be accepted. On one hand, the ISO 20022 format is more technically complicated to create than a vanilla spreadsheet. On the other hand, the great benefit of ISO 20022 is that a large amount of the data validation is contained within the format definition itself — the successful creation of a file already guarantees the quality of a large part of the data being submitted, even before it reaches the TR.

Once the data has been received, the TR will reconfirm the validity of the data in the file and carry out other mandatory verifications, such as:

- Ensuring the unique transaction identifier (UTI) provided has not previously been used for another trade.

- Validating certain data elements against reference data lists (for example legal entity identifiers (LEIs), currency codes, venue codes).
- Preventing illogical workflows (for example preventing a modification from being reported against a trade that has already matured).

Records that pass all the checks will be submitted to the TR. For those that do not, firms are obliged to correct the errors and resubmit the affected records within the reporting deadline.

## RECONCILIATION

SFTR, like EMIR, is a dual-sided reporting regime. This means that trades must be reported from both counterparties' perspectives, and the details reported must match one another, or be corrected until they do. The reconciliation of reported trades is carried out by the TRs on a daily basis and will follow the technical standards laid down by the European Securities and Markets Authority (ESMA). For SFTR, we expect those to replicate (to a greater or lesser extent) the process that TRs follow under EMIR:

1. The TR checks each trade it holds to verify whether that trade should be submitted for reconciliation — trades reported against individuals and non-European economic area (EEA) counterparties, neither of which have a reporting obligation under the regulation, will be excluded.
2. For each trade that remains in scope after step 1, the TR attempts to find a pairing record internally within its own database. In order to pair, the UTIs must match, and the LEIs of the two counterparties must be the mirror image of one another. For this stage to function successfully, it is therefore crucial that the correct UTIs and LEIs are used on the trade in order to locate the other side.

3. In cases where the TR cannot find the pair to the trade internally, it will include the UTI and both counterparty LEIs in a list to be exchanged with all the other TRs. This is called the requested list.
4. Once per day, all the TRs exchange their requested list with all the other TRs. Each TR then searches its database in an attempt to locate the pair for the other TRs' records.
5. When it identifies a trade that another TR is looking for, it includes the trade details in a file created only for the TR that was searching for that trade. This is called the trade data details file.
6. When all the trades have been searched for, the trade data details files are sent to the other TRs, and the TR runs the reconciliation.
7. Once run, the TR will show or report to the reporting firm the results of the reconciliation, highlighting which fields do not match and need to be amended.

Whenever an amendment is made to a trade, the TR will automatically resubmit that trade to the inter-TR reconciliation process again, so that the modified details are reconciled.

And any trades that do not find a pair are included in the requested list again the following day.

## THE CONCERNS

As a TR, we hear two main refrains when we speak to the industry about SFTR reporting, both of which relate to the inter-TR reconciliation:

1. If we use a different TR to our counterparty, we will never achieve a match in the inter-TR reconciliation.
2. It is not feasible that we will be able to match every field exactly with our counterparty.

## THE REALITY

On the first point, and as described above, the first step to successful reconciliation is ensuring that reports are made using the same UTIs and LEIs as the counterparty — that requirement is the same whether firms report to the same TR as their counterparty or a different one. It is worth highlighting that the *inter*-TR reconciliation process (where the TR looks for a pair to each trade in another TR) follows exactly the same logic as the *intra*-TR reconciliation (where the TR searches its own database for the pair). The software code that runs is completely agnostic as to the source of the other side of the trade; therefore, in reality, it makes no difference to the success or failure of the process as to whether both counterparties report to the same TR or not. On that basis, and contrary to popular opinion, there is no benefit to ‘letting the reconciliation tail wag the reporting dog’ — firms are entirely at liberty to choose the reporting service and TR expertise that best support them and their business needs rather than choosing the same TR as their major counterparty.

On the second point, and, again, contrary to popular belief, the *inter*-TR reconciliation does not require a perfect match on every field. TRs jointly apply various methods to reduce extraneous reconciliation failures under EMIR reporting, for example:

- Free text fields are excluded from reconciliation — as they cannot reasonably be expected to match.
- Some numeric fields have tolerances or rounding applied — some trading systems hold numeric values to differing numbers of decimal places or use different exchange rates to convert between currencies.
- Some date and time fields have tolerances applied — where trades have been confirmed nonelectronically, for example TRs only confirm that the dates match

between the two sides of the trades, not the times.

- Some fields are considered ‘must match’ fields; others are ‘should match’, some are ‘will not match’ — and the processing reflects that logic.

## OUR RECOMMENDATIONS

Given our experience of reporting under EMIR, of what works, not just in terms of carrying out the reporting in a timely and accurate manner, but also that all-important *inter*-TR reconciliation process, we note that the following strategies have been the most effective in getting high rates of reconciliation success:

### Delegating reporting to a counterparty

In contrast to the derivatives world, where counterparties to trades are already in possession of virtually all data that needs to be reported under EMIR, in the securities financing world, the data required to be reported by both firms for SFTR is asynchronously distributed, with clearers, lenders and brokers holding the lion’s share of the information.

On that basis, and in order to simplify workflows between counterparties, we recommend that firms consider delegating reporting to their clearer, lender or broker if that service is being offered. What must be borne in mind, however, is that delegated reporting in no way gets firms ‘off the hook’ in ensuring the timeliness, quality and accuracy of the reporting — that responsibility *cannot* be delegated, and firms must, therefore, be able to demonstrate that they have established workflows and processes in place to review what has been reported on their behalf and to correct any errors that have occurred.

### Using a third party

Similar to the above, where an IT platform or service is being used, for trading or for

trade confirmation, for example, it may well be that the provider will, additionally, offer an SFTR reporting service. The exact service offering is likely to vary across providers, with some offering a full end-to-end service whereas others will prepare the data records on behalf of the firm for them to submit directly to the TR.

### **Sharing the UTI itself, not the UTI generation algorithm**

UTIs are a novel concept in each reporting regime they are extended to. The concerns in the securities financing world reflect those we saw particularly in over-the-counter (OTC) derivative trading for EMIR — who will generate the UTI? How will they create it? How will they distribute it? How does one know that they have used the same UTI as their counterparty? How can one be sure the UTI is generated in time for them to complete their reporting?

With the assistance of some of the trade associations, common ground was established under EMIR in answering some of these questions.

As trade principals, many central counterparties (CCPs) took responsibility for generating the UTI for themselves and their counterparty, reflecting the workflow that had been adopted for Dodd Frank reporting in the US. Similarly, many clearing members (CMs) generated for themselves and their client. The method by which those UTIs were shared followed one of two methods.

Most CCPs publish the algorithm that they use to create the UTI so that the CM can create that same UTI in its systems. This saves the CCP from having to distribute the UTI to the CM in a manner that is timely enough that the CM can use it in its own transaction reports. While straightforward enough in theory, the implementation of this process has not been entirely successful. First, it results in CMs having to implement multiple UTI generation algorithms, as each

CCP has created their own unique algorithm. Secondly, paper-based explanations of how the individual algorithms function are not necessarily implemented directly as anticipated — we have seen numerous cases where two parties, using the same algorithm, compute differing UTIs.

A small number of CCPs, however, forward the UTI they have generated in their own systems to their CM with the clearing confirmation, and the CM directly consumes that UTI. This method requires new workflows to be put in place in order to share and consume the UTI, but it does guarantee that the same UTI will be used by both parties when they report the trade — going a long way to ensuring that trade pairing takes place successfully.

### **Working actively to resolve issues**

Firms that have been involved in transaction and other regulatory reporting for some time understand that remaining in compliance with the reporting requirements demands unremitting effort and scrutiny of both the data being reported and the processes used to complete the reporting — they dedicate staff to working actively to resolve issues in their reporting and look to apply constant improvements. As we have seen when addressing specific areas of concern with our clients, hard work in this regard does pay off and, given the amount of data to be reported, issues that are left unchecked only compound to create knock-on effects.

A salutary example of the issues that can arise when transaction reporting processes are not subject to sufficient scrutiny and independent review can be found on the Financial Conduct Authority (FCA) website at [www.fca.org.uk](http://www.fca.org.uk) by searching for ‘EMIR fine’.

To summarise the case, on 23rd October, 2017, the FCA issued the first ever fine across the EU for misreporting under the EMIR regime — failures that resulted in a

£34.5m sanction for the firm in question. The report makes for sobering reading and acts as a warning for reporting firms regarding the importance of:

- Sufficient resourcing of reporting teams.
- Ongoing and pro-active independent testing.
- Addressing identified risks and audit findings.
- Senior management oversight and accountability for the reporting workstream.

### **WHAT TO LOOK FOR IN A REPORTING SERVICE PROVIDER OR TRADE REPOSITORY**

However firms conduct their reporting, whether through a third party or counterparty, or by directly submitting reports to their chosen TR, it is clear that transaction reporting is not a ‘fire and forget’ endeavour. It requires active management and remediation in order to keep in compliance with the regulation — and this is an area in which the reporting service provider or TRs can assist.

Choosing whether to report directly to a TR or via a third party or counterparty may well hinge solely on the following point: if a firm’s own systems or data warehouse can generate all the data points required and within the reporting deadline, a direct relationship with a TR, offering workflow simplicity and consolidated data views and management, may represent the optimal choice. If, however, firms require some of the necessary data elements to be sourced from outside their own systems and processes, then reporting via a third party or counterparty may be the most efficient approach.

Firms will need to receive information from their TR or reporting service provider about their reported data so that they can identify issues and carry out pro-active, focused investigations into any problem areas. Some of the information to be

provided by TRs is described in the draft RTS and, optimally, this will consist of regular information regarding:

- Report submission volumes.
- Resolving late submission issues.
- Resolving general TR validation failures — errors must be corrected and the affected records resubmitted within the reporting deadline.
- Resolving LEI validation failures — virtually every party to the trade requires an LEI, which go through cycles of expiry and renewal, as well as periodic changes.
- Resolving TR pairing failures with counterparties.
- Resolving TR reconciliation breaks with counterparties.
- Information about the reconciliation rates versus each counterparty — this will allow for targeted investigation of counterparty-specific issues.
- Information about the individual fields that are causing the reconciliation failures — for highlighting field-specific population inconsistencies.
- Periodic reporting performance reviews — MIS for audit and compliance purposes.

Firms should also select a provider or TR that runs a helpdesk dedicated to their regulatory reporting service, who understands the specifics of the securities financing business and the SFTR regulation and who can support them in resolving any issues in a manner timely enough to maintain a firm’s compliance with the regulation.

### **PRACTICAL FIRST STEPS**

1. Trade associations whose membership is engaged in SFT business lines are setting up dedicated SFTR working groups and task forces, aimed at reaching industry consensus on best booking and reporting practice, and providing lines of communication between market practitioners and

regulatory bodies. Participating in these groups provides an opportunity to stay abreast of developments as the reporting start date comes closer, as well as engaging with industry peers on resolving some of the issues that are widely anticipated as problematic ahead of implementation.

2. In a similar vein, there are many intermediaries who will provide solutions in this space. Even where firms plan to report directly to their chosen TR, we recommend reaching out to them and attending some of the various briefings and webinars that they provide. A number of intermediaries are highly informed and can assist in crystallising some of the challenges that lie ahead.
3. TRs are now publicising whether they will offer an SFTR service; therefore the opportunity now exists to engage with them in detail and — if proportionate — embark upon a request for information/request for proposal (RfI/RfP) process. It is widely anticipated that not all EMIR TRs will become SFTR TRs, and, furthermore, it is not automatically safe to assume that a firm's EMIR TR or Dodd Frank SDR (swap data repository) will represent the best choice of TR for SFTR. We recommend that firms test TRs' credentials and commitment to the service. The level and

quality of discussions on the topic should provide a preliminary indication of their likely readiness in terms of test environments, legal documentation, onboarding and expertise to guide firms through the process.

## CONCLUSION

Pragmatically speaking, perfection is not expected on day one; however, regulators have promised that 'noncompliance will always be more expensive than compliance', and arguably the total cost of compliance is more than just the monthly fee paid to the service provider or TR. Early engagement with industry subject matter experts and due diligence in evaluating the various service offerings that are starting to surface will reap dividends in the long run, demonstrating to senior management, regulators and clients alike that the necessary systems and controls are in place — and avoiding the financial and reputational damage that accompanies a breach.

## AUTHOR'S NOTE

- (1) A version of this paper first appeared in the International Securities Lending Association's Securities Lending Market Report, February 2018.