



Coalition for Derivatives End-Users



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Improving Derivatives Transparency: The Merits of an Entity-based Reporting Framework

Regulators now have more derivatives transaction data at their fingertips than ever before. But using this data to develop an aggregate view of market exposures and to monitor risks that pose a threat to the stability of the financial system has been challenging – partly due to different reporting rules among jurisdictions and variations in data reporting formats.

National regulators and global regulatory bodies have ramped up their efforts to tackle these problems, but one issue has not yet been put on the global to-do list: an agreement on which party should report the trade. While many regulators recognize that the reporting responsibility should rest solely with a single party (typically the clearing house for a cleared trade and the dealer counterparty for a bilateral transaction), some require both parties to report the full terms of the trade separately. Even in cases where only one party is required to report, some jurisdictions require the non-reporting entity to confirm the accuracy of the data reported by the other party, to supplement the data, or to confirm it is not required to report a trade.

The rationale is that these forms of dual-sided reporting obligations will improve the quality of the data reported. However, evidence has shown this is not the case. For instance, confirmation execution rates are generally at or above 90%, whereas pairing rates at trade repositories used in dual-sided reporting regimes are around 60%. Matching rates are assumed to be even lower than this. Dual-sided reporting also creates cost and complexity for end users, with little apparent gain. The aggregate expenditure for market participants implementing the European Union's dual-sided system is estimated to exceed €100 million.

The Alternative Investment Management Association, the Association of Corporate Treasurers, the Australian Financial Markets Association, the US Chamber of Commerce's Center for Capital Markets Competitiveness, the Coalition for Derivatives End-Users, the Global FX Division of the Global Financial Markets Association, ICI Global, the Investment Association, the International Swaps and Derivatives Association (ISDA), Managed Funds Association, the US National Association of Manufacturers, the Securities Industry and Financial Markets Association's Asset Management Group, and Pensions Europe believe that an entity-based reporting framework – where sole responsibility for the accuracy of the reported data is assigned to one counterparty via an automated hierarchy system – is an essential counterpart to high-level harmonization of data reporting standards. A streamlined approach to reporting would significantly reduce the operational complexity associated with current reporting requirements, reduce costs and, in almost all cases, eliminate the reporting burden for non-dealer derivatives users. The simplification of the reporting process, combined with initiatives by global regulators to improve the clarity and specificity of their requirements, would lead to improvements in data quality.

Benefits of Entity-based Reporting

- 1. Entity-based reporting will reduce the cost and burden of transaction reporting currently placed on end users.** Global trade reporting requirements are technically and legally complex. The cost and effort of implementing and maintaining reporting and data verification architectures is significant. Reporting burdens should be placed on the participants with existing reporting infrastructures and greater technological resources. This is most likely to be clearing houses for cleared trades and dealers for bilateral transactions.
- 2. Entity-based reporting will eliminate the duplication and replication of other regulatory requirements.** Legal confirmation processes are well established, providing a direct and built-in validation of transaction terms between counterparties. In addition, regulators require a number of reconciliation and control processes to identify and resolve material discrepancies, including mandates for timely trade confirmation, portfolio reconciliation, portfolio valuation and dispute resolution. Trade reporting is not an effective or necessary additional tool to verify or match transaction terms between parties.
- 3. Streamlined, clarified reporting obligations are a more effective tool to improve the quality and accuracy of reported transactional data.** Variations in reported data are widely attributed to different interpretations of how the information should be represented. This is partly due to a lack of specificity within and inconsistencies among global reporting regulations. Risk-mitigation techniques such as trade confirmation, settlement and portfolio reconciliation have low levels of discrepancies relative to the matching statistics of dual-sided reporting regimes. This shows that it is a lack of clarity in the required data that is causing the recorded discrepancies rather than disputes over the material economics of a trade. Reporting entities, trade repositories and regulators are actively engaged in efforts to address these shortcomings in order to improve data quality in more effective ways.
- 4. Entity-based reporting will make high-level, multi-jurisdictional harmonization of reporting requirements easier and more effective.** The combination of greater harmonization among global trade reporting requirements and entity-based reporting will produce greater operational efficiency and globally consistent data sets. Leaving dual-sided reporting in place creates significant extra costs and operational burdens, without the benefit of significantly better data quality.

MERITS OF AN ENTITY-BASED REPORTING FRAMEWORK

ISDA published a paper in February 2015¹ that outlined key principles and action steps that all stakeholders should consider adopting to improve the quality and consistency of derivatives trade data, highlighting the importance of global harmonization of trade reporting requirements. Since then, global regulators have focused on improving the quality and consistency of reported data through the Committee on Payments and Market Infrastructures (CPMI) and International Organization of Securities Commission's (IOSCO) data harmonization working group.

More needs to be done. Many regulators recognize that the obligation to report transaction data should be significantly or solely placed on a single market participant. However, other regulators believe both parties should report, or that the non-reporting party should supplement and/or affirm the accuracy of the reported data. Some reporting entities are even required to confirm, on a transaction-by-transaction basis, that a trade is not reportable under a particular regulatory regime.

The associations believe these dual-sided reporting requirements create unnecessary, duplicative obligations that significantly increase costs for derivatives end users and have not led to improved data quality.

1. Entity-based reporting will reduce the cost and burden of transaction reporting currently placed on end users.

The cost and effort of establishing and maintaining the reporting infrastructure to satisfy obligations in one or multiple jurisdictions are significant. These costs are substantial for major market participants, but are much more challenging for those end-user counterparties that lack the infrastructure and resources to build a reporting mechanism or invest in a third-party provider. This may inhibit the ability of some end users to participate in the derivatives market.

In some jurisdictions, market participants have already spent time and resources to establish reporting mechanisms, but this does not justify the continuation of duplicative reporting obligations, given the substantial ongoing costs to maintain reporting structures and amend them as regulations develop.

ISDA, in coordination with certain end-user trade associations, recently conducted a survey on the costs for derivatives end users associated with dual-sided reporting under the European Market Infrastructure Regulation (EMIR). The survey asked end users to provide the initial cost to their firms of implementing reporting technologies, the annual cost of maintaining those technologies, and the resources involved in reporting transaction data. The survey found that nearly 45% of respondents incurred annual costs of over €100,000 – a level that exceeds the total yearly compensation of at least one employee per firm. For some institutions, the burden is much greater: 7.3% of end users surveyed spent between €500,000 and €2 million per year, and 4.4% spent more than €2 million per annum. These costs are a significant burden, particularly for smaller end users. As potentially thousands of firms are subject to EMIR, the aggregate expense of the dual-sided reporting regime is estimated to exceed €100 million.

The cost burden can also be significant for parties that are not required to report complete records of transaction data. For example, some regulators require the 'non-reporting' party to report transaction data to supplement the information submitted by the reporting party, to report that they 'affirm' the accuracy of the data reported by the other party, or to verify that their side of the trade is not reportable (eg, through trade 'suppression').

¹ <http://isda.link/datapaper>

These obligations result in overlapping reporting obligations because these non-reporting parties still have to sign up to a trade repository, or potentially multiple trade repositories, depending on where data has been reported. They also need to build mechanisms to report supplemental information, or to review and affirm data. As the data submitted by the reporting party is translated into the format required by the relevant regulations and/or the trade repository, it will not align with the way in which the non-reporting party captures the data in its own systems. In order to automate reconciliation and verification of the information, the non-reporting party would need to transform its data, largely undermining any purported reduced burden of its secondary obligations.

Although most jurisdictions allow end users to delegate reporting obligations to the other counterparty, these arrangements involve cost, effort and risk. Delegated reporting therefore does not eliminate the burden for end users. Apart from having to maintain and reconcile data across multiple delegated reporting agreements, non-reporting firms also face significant ongoing costs in verifying that trades have been correctly reported on their behalf, and in reconciling this data if an inconsistency is found. Dealer-specific delegated reporting services make it difficult for non-dealers to reconcile across multiple sources, creating a challenging operational environment and exacerbating data-quality issues.

The need for end users to transact with a dealer that provides delegated reporting services also limits their execution options and places an artificial constraint on liquidity. As delegated reporting offerings do not cover the reporting of intragroup transactions, many end users still need to develop the infrastructure to report these trades. The end user survey found that 75% of respondents said they still need to report transactions (such as intragroup trades), so only 25% rely solely on a delegated reporting model. This model also puts additional requirements on dealer counterparties without actually providing a two-sided view of the data.

In light of this, the associations believe regulators should move to an entity-based reporting regime on a global basis, and the reporting party should be the counterparty with the most robust existing reporting infrastructure and with the timeliest access to the complete data. This is most likely to be the clearing house for cleared trades and the dealer for bilateral transactions. Where the two counterparties have equal capabilities, they should agree in advance which party will report, based on existing industry standards². The party with the reporting obligation for a transaction should be directly responsible for the accuracy of the data, and the non-reporting party should not be obligated to verify the data or confirm it is not required to report the transaction.

The associations also believe intragroup trades for non-financial end-user entities should be exempt from reporting requirements, as data from these transactions does not contribute to an overall understanding of systemic risk. This reporting obligation also places disproportionate costs on end users.

2. Entity-based reporting will eliminate the duplication and replication of other regulatory requirements.

Alongside monitoring the build-up of systemic risk, some regulators believe a dual-sided reporting framework can serve as a dispute-resolution mechanism. However, market mechanisms and specific regulatory requirements designed to link and match trades and resolve disputes already exist. Therefore, using duplicative reporting obligations for these purposes is unnecessary.

² ISDA Asset Class Tie-breaker Logic, March 2016: <http://isda.link/assetclasstiebreaker>

Trade reporting is not, and should not be, a means by which parties agree to the terms of their transactions. Execution methods and confirmation processes, which are well-established and legally binding, serve this role. Regulators require transparency on transaction terms, but it is neither necessary nor effective to create redundant requirements that conflict with those that currently exist in bilateral processes.

Separate from transaction reporting, regulators already impose a number of requirements on market participants to verify they are in agreement on the terms of their transactions and their relevant valuations. These mandates for timely trade confirmation, portfolio reconciliation, portfolio valuation and dispute resolution help to mitigate the risk of any materially significant discrepancies and result in the correction of errors in the economic terms of the reported trade.

An additional regulatory rationale for dual-sided reporting is to reduce the risk of parties inadvertently failing to report a trade. However, this risk is very low given that dealers have invested significant resources in automating their reporting processes and establishing compliance staff and procedures to ensure trades are reported in accordance with the regulations in each jurisdiction.

The additional burden placed on non-dealers to report, supplement or verify transaction data, or the reportability of such data, is unnecessary given the extensive reconciliation requirements of global regulators and established bilateral processes for obtaining transaction certainty.

3. Streamlined, clarified reporting obligations are a more effective tool to improve the quality or accuracy of reported transactional data than overlapping reporting obligations.

Efforts to address discrepancies in transaction reporting show that differences in the data reported by each party for the same trades do not mean the parties do not agree on the terms of the transaction. In almost all cases, the discrepancy can be attributed to either: (i) fields that are required for reporting, but are not material terms of the transaction or its confirmation (ie, the unique transaction identifier (UTI) or a party's legal entity identifier); or (ii) a difference in the way the data for the field is reported (eg, notional currency in ISO 4217 value (CNY) versus use of a non-ISO value (CNH)).

- (i) Trade reporting regulations include myriad requirements for data elements that are not part of the trade execution or confirmation process, but are useful to regulators for the purposes of understanding, comparing or aggregating the trade data. These include trade, product and party identifiers, as well as jurisdiction-specific party classifications. These data elements are generally not difficult for a single party to report. But if the information needs to be communicated between the parties in advance of reporting for consistent application (as with UTIs), then the challenge is significant – particularly in cases where an electronic method is not available to exchange the data.

Regulations may also require the reporting of trade terms that are standard for certain products and are defined or specified in the documentation incorporated by reference. This could include terms specified in the applicable ISDA product definitions (eg, the 2014 ISDA Credit Derivatives Definitions) or the ISDA Master Agreement between the parties. As these terms are standard to the relevant trades or to all transactions between the parties, they are not separately agreed at the point of execution, and it may be unnecessary to include them in the confirmation. Regardless, regulators in some jurisdictions may require these terms to be explicitly reported. As the parties would not otherwise confirm these terms between themselves, they may not report them in a uniform fashion.

(ii) Firms have individualized trade-capture systems, and therefore book and house transaction data differently. This data must be transformed into a standardized format for transaction reporting. Where the regulatory requirements for permitted values or formats are not specific or do not align with market-standard representations, they may be interpreted and implemented differently by trade repositories and reporting entities. Resolving these different representations therefore does not involve material trade discrepancies between the parties, but only the way in which that data is presented to the trade repository.

In these cases, it is the data representation that does not match, rather than the material terms of the transaction. Therefore, a uniform representation by both parties does not necessarily improve the accuracy of the data available to regulators. The need to reconcile the data in a dual-sided reporting regime detracts, rather than aids, the ability of regulators to rely on and use the data.

Risk-mitigation techniques such as confirmations, settlements and portfolio reconciliation have low levels of discrepancies relative to the matching statistics of reported data in dual-sided regimes. The vast majority of confirmations are executed within a day, providing parties with legal certainty on the material economic terms of their transactions. Confirmation rates for most asset classes are at or above 90% at any given point.

In comparison, pairing (where the legal and trade identifiers to a particular transaction are correctly aligned) runs at a success rate of around 60% at trade repositories for dual-sided reporting regimes, according to ISDA analysis. Matching (where all trade data is correctly submitted by both counterparties) can be assumed to occur even less frequently. This suggests that it is the extra fields required for reporting non-material terms that lead to inconsistencies and poor pairing rates. Eliminating dual-sided reporting obligations would allow parties to reallocate resources used to resolve these non-material breaks to focus instead on the quality of their own reported data, therefore improving the data available to regulators.

Reporting entities, trade repositories and regulators are actively engaged in various efforts to address the need for specificity, clarity and consistency with respect to reportable data requirements. These collective efforts will more effectively improve the quality of reported data than requirements that involve both parties in agreeing on the representation of reported data.

4. Entity-based reporting will make high-level, multi-jurisdictional harmonization of reporting requirements easier and more effective.

Dual-sided reporting obligations create an enormous additional burden on market participants to report and maintain transaction data that is already being reported by their counterparty. This duplicative data undermines rather than enhances use of the data by regulators, as it falsely implies the parties have material discrepancies. Requirements for a non-reporting party to supplement or verify reported data, or confirm it does not have an obligation to report, are inconsistent with the regulatory goal of limiting the burden placed on both counterparties. The cost and effort for both end-user counterparties and dealers to comply with these requirements are significant. Industry recommendations and standards for determining which party is best positioned to report, or otherwise agree which party should report, are already established and should be leveraged consistently on a global basis.

Global regulators are actively working to improve the quality and consistency of data requirements, individually and through CPMI-IOSCO, in order to both increase the quality of the data and to facilitate global data aggregation and analysis. If a single counterparty could report a transaction globally in the relevant jurisdictions using the same data representation, the task of analyzing globally aggregated data would be much more manageable.

The harmonization of reporting obligations globally reduces the cost and improves the efficiency and consistency of reporting. An aligned approach where the single party best situated to report is assigned full responsibility for the reporting process is an important aspect of those aims that should be carefully reconsidered by global regulators. Absent a true benefit to the quality of the data available to meet regulatory mandates, duplicative responsibility for the accuracy of transactional data cannot be rationalized.

NEXT STEPS

- **An entity-based reporting framework should be adopted across jurisdictions**
Dual-sided reporting is complex, costly, and has not provided demonstrably improved levels of data quality. An entity-based reporting framework, where sole reporting responsibility is assigned to one counterparty (typically a dealer or central counterparty), can provide the requisite level of trade information and reduce burdens on derivatives end users.
- **Existing processes, and not dual-sided reporting, should be used to identify mismatches in trade terms**
Execution and confirmation processes already serve an established and legally binding role in rooting out discrepancies in trade terms. Using trade reporting for this process is unnecessary, ineffective, and adds further complexity to the process.
- **A tiebreaker methodology for determining the responsible reporting party should be implemented consistently**
The associations believe that the reporting entity and UTI-generating party for any specific trade can be successfully determined by application of a reporting party hierarchy and ‘tie-breaker logic’. ISDA has developed an industry-agreed tie-breaker logic that is specific to each individual asset class. A dealer will always be the reporting entity when transacting with a non-dealer counterparty, and two dealers will apply the tie-breaker logic to determine which firm will act as the reporting party when executing a trade between themselves. In a prime brokerage scenario, where two offsetting trades are executed, the prime broker will be the designated reporting entity for its trade with the client, and the executing broker will be the designated reporting party for the trade with the prime broker.
- **Legal responsibility for non-reporting counterparties to verify trade reports should be removed**
Some jurisdictions that assign reporting responsibility to one counterparty still require the non-reporting counterparty to verify the accuracy of the data, supplement the data or provide information associated with the trade, such as whether it is required to report or not. This is dual-sided reporting in disguise, and places unnecessary cost burdens on end users.
- **Greater focus should be placed on global data harmonization efforts**
Entity-based reporting can only be fully successful within a global, fully harmonized reporting system. Global regulators should align their reporting rules, and data fields should be based on existing market practices. Data harmonization should be led by CPMI-IOSCO to ensure global consistency.