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European Securities and Markets Authority Publishes New Guidelines to Apply From May 2012 for Regulation of Automated and Algorithmic Trading in the EU

On 22 December 2011, the European Securities and Markets Authority ("**ESMA**") published guidelines (the "**Guidelines**") on EU electronic trading systems, trading algorithms and the provision by investment firms of direct market or sponsored trading system access. ESMA is the European Supervisory Authority given responsibility in early 2011 for oversight and supervision of EU securities markets. The Guidelines interpret **existing** EU requirements set out in the Markets in Financial Instruments Directive ("**MiFID**") and Market Abuse Directive and are intended to come into effect in May 2012.

The Guidelines are **separate** from the European Commission's recent MiFID II proposals, detailed below, covering algorithmic and high frequency trading, which are expected to be implemented in or around 2014.

The Guidelines apply to:

- EU Regulated Markets ("**RMs**") and Multilateral Trading Facilities ("**MTFs**") (also referred to as "**Trading Platforms**") which operate electronic trading systems located within the EU that are used to deal in securities and derivatives ("**Electronic Trading Systems**");
- EU-regulated MiFID and third country investment firms who directly or indirectly access Electronic Trading Systems or who provide direct market access ("**DMA**") or sponsored access ("**SA**") to such systems. Investment firms include banks, broker-dealers and advisory and discretionary portfolio managers with EU establishments;
- UCITS and non-UCITS scheme operators and insurers regulated in the EU but which are not MiFID investment firms. Although they are not formally covered by the Guidelines they will be **indirectly** impacted through requirements that apply to RMs and MTFs and through requirements imposed on MiFID investment firms who may give them DMA or SA. EU-based funds could also in theory fall into this category, however in practice most trading for these funds will be carried out by portfolio managers either directly or through broker-dealers; and
- Firms and funds that are not regulated in the EU and who access Electronic Trading Systems directly or through DMA and SA. They too will be indirectly impacted through requirements imposed on RMs, MTFs and MiFID investment firms. This category includes firms and funds with head offices outside the EU and whose activities do not require EU regulation. It also includes firms and funds with head offices inside the EU who use exemptions available under MiFID – *e.g.* some proprietary traders, all self-managed funds and all firms who use group exemptions.

Main Highlights

- EU Trading Platforms and EU-regulated investment firms must ensure the robustness of their Electronic Trading Systems. For investment firms, this includes the testing of the trading algorithms they use.
- EU Trading Platforms must impose specific requirements for investment firms who are based outside the EU and are not EU-regulated. In particular, due diligence on such non-EU firms is likely to tighten in response to these requirements. EU-based traders using MiFID proprietary trading exemptions, who are therefore unregulated also will be subject to similar requirements.
- EU Trading Platforms and EU-regulated investment firms must minimise the extent to which Electronic Trading Systems are used for market abuse.
- Specific requirements imposed upon EU Trading Platforms or EU-regulated investment firms where DMA/SA is given to third parties who are not Trading Platform members or participants.

Our view is that the Guidelines in the main are declaratory of best practice and, in that respect, are helpful. They are a welcome attempt to harmonise requirements in the major European markets. In themselves, they are unlikely to satisfy buy-side complaints that electronic securities and derivatives markets are distorted by the activities of high frequency traders. Buy-side concerns may be addressed by MiFID II proposals to require high frequency traders to adopt quasi-market making roles and to bring unregulated high frequency traders within the scope of EU regulation. However, these proposals could be watered down in the consultation process. Unfortunately we do not believe that implementation of the Guidelines will prevent another Flash Crash. Market commentators have pointed to the complexity of financial markets, the intricacies of which are not well understood. Until electronic systems are created that can predict and mitigate an abnormal systems-produced crash, the risk of a repeat will not disappear. The Guidelines are, however, a first step in the attempt to deal with a serious issue.

Detail on ESMA Guidelines

The Guidelines' impetus comes from the issues raised by the May 2010 Flash Crash that affected US and EU security and derivative markets, and which has never been adequately explained. There are fears that the episode may not be a one-off and, therefore, regulators should take action to prevent a recurrence.

Guidelines 1 & 2: Organisational requirements for RMs' and MTFs' Electronic Trading Systems and organisational requirements for investment firms' use of Electronic Trading Systems (including trading algorithms)

EU Trading Platforms must ensure that their Electronic Trading Systems are well adapted and robust enough to ensure market continuity and regularity. In particular, they must:

- Have in place a clear and formalised governance process which ensures that all relevant considerations, including commercial, technical, risk and compliance, are given due weight;
- Ensure sufficient capacity to accommodate reasonably foreseeable volumes of messaging and allow for capacity increases in order to respond to rising message flow and emergency situations;

- Maintain effective business continuity arrangements;
- Make use of clearly delineated development and testing methodologies before deploying new systems and updates;
- Conduct real time monitoring and periodic review of their Electronic Trading Systems, and be able to adequately deal with problems identified as soon as reasonably possible;
- Have procedures and arrangements for physical and electronic security to protect their Electronic Trading Systems from misuse or unauthorised access and to ensure data integrity;
- Have staff recruitment and training procedures which ensure the employment of sufficiently skilled and expert staff; and
- Keep records which are sufficiently detailed to enable national EU regulators to monitor compliance with relevant obligations.

EU-regulated investment firms must ensure the robustness of their use of Electronic Trading Systems, including their use of trading algorithms. They must have similar processes to achieve the goals for Trading Platforms which are set out above. In addition, firms should ensure that algorithms work effectively in stressed market conditions and ensure their use does not prejudice compliance with market rules and regulatory obligations. Trading algorithms will need to be tested in a controlled manner in real time live environments. Firms are required to conduct further tests if the markets in which the algorithms are used change. The requirement to test algorithms may hamper the trading strategies of some high frequency traders by delaying full roll out of the algorithm and therefore preventing the maximisation of the potential of a trading strategy.

Guidelines 3 & 4: Organisational requirements to enable RMs, MTFs and investment firms promote fair and orderly trading in automated trading environments

RMs and MTFs must ensure fair and orderly trading on their Electronic Trading Systems by:

- Performing adequate due diligence on non-EU firms who apply to become members, participants or users of Electronic Trading Systems;
- Putting in place organisational requirements for non-EU members or participants, including requirements on the monitoring of trading against the rules of the Trading Platform and the management of risk. Trading Platforms' rules should also require such firms to follow the Guidelines. However Trading Platforms are permitted to take into account the controls imposed on firms authorised outside the EU;
- Imposing pre- and post-trade controls, in particularly controls on filtering order price and quantity;
- Ensuring they are able to limit access of a member or a participant to their markets and to cancel, amend or correct a transaction;
- Monitoring the market in real time for possible signs of disorderly trading;
- Having measures to cope with excessive flooding of the order book;
- Preventing capacity limits from being breached; and
- Having arrangements (for example, volatility interruptions or automatic rejection of orders which are outside certain set volume and price thresholds) to constrain trading or to halt trading when necessary to maintain an orderly market.

The Guidelines also require investment firms to ensure that their automated trading activities and provision of DMA/SA access promote fair and orderly automated trading. Firms must:

- Have the ability to automatically block/cancel orders on account of breaches in trade size, trading permissions or risk management thresholds;
- Have procedures and arrangements to override pre-trade controls so that automatically blocked orders can be re-submitted;
- Ensure that employees involved in order entry have adequate prior training on order entry procedures and Trading Platforms requirements;
- Monitor markets in real time, including from a cross-market perspective, for potential signs of disorderly trading; and
- Ensure that they have control of messaging traffic to individual Trading Platforms.

Guidelines 5 & 6: Organisational requirements for RMs, MTFs and investment firms to prevent market abuse (in particular market manipulation) in automated trading environments

Trading Platforms must ensure that their systems prevent, and identify conduct that may involve, market abuse. Investment firms must have policies and procedures in place to minimise the risk that their automated trading activity gives rise to market abuse. This will be welcome to buy-side firms who may be more at risk from what the Guidelines describe as:

- **Ping orders** – entering small orders in order to ascertain the level of hidden orders and particularly used to assess what is resting on a dark platform;
- **Quote stuffing** - entering large numbers of orders and/or cancellations/updates to orders so as to create uncertainty for other participants;
- **Momentum ignition** – entering orders or a series of orders intended to start or exacerbate a trend, and to encourage other participants to accelerate or extend the trend in order to create an opportunity to unwind/open a position at a favourable price;
- **Layering and Spoofing** - submitting multiple orders often away from “the touch” on one side of the order book with the intention of executing a trade on the other side of the order book. Once that trade has taken place, the manipulative orders will be removed.

Some of these behaviours may have led buy-side firms to seek out dark pools to protect their clients, leading to execution venue fragmentation which the MiFID II proposals will have to address. It remains to be seen, however, whether the Guidelines will lead to more trust in the fairness and the soundness of prices found on lit markets.

To prevent market abuse (in particularly market manipulation), Trading Platforms should have:

- Sufficiently skilled staff to monitor automated trading activity and identify suspicious behaviour;
- Systems with sufficient capacity to accommodate high frequency generation of orders and transactions and low latency transmission, in order to monitor orders and transactions and any behaviour which may involve market abuse. The systems should also allow Trading Platforms to trace transactions and entered/cancelled orders which may involve market manipulation;
- Arrangements for the identification and reporting of suspicious transactions and orders;

- Periodic reviews and internal audits of these procedures and arrangements; and
- Record keeping and effective audit trails showing how each market abuse alert was dealt with and whether or not a report was made to the relevant regulators and authorities.

The policies and procedures of investment firms engaging in automated trading activities should include:

- Procedures to ensure that compliance staff have sufficient expertise, skill and authority to challenge trading staff when trading raises market abuse suspicions;
- Initial and regular market abuse training for trading staff;
- Monitoring of individuals' and algorithms' trading. This should include systems which can flag any behaviour likely to give rise to market abuse suspicions, including (where the firm has sight of this) cross-market behaviour;
- Suspicious transactions and order reporting procedures; and
- Periodic reviews, internal audits and record keeping procedures.

Guidelines 7 & 8: Organisational requirements for RMs and MTFs whose members, participants and users provide direct market access/sponsored access and organisational requirements for investment firms that provide such access

Trading Platforms which allow users to offer DMA/SA to EU and non-EU third parties must impose a number of rules requiring participants to ensure that access is compatible with fair and orderly trading. These include:

- Making clear that the member, participant or user is solely responsible for all messages, including orders entered under its own trading codes and therefore may be subject to interventions and sanctions for any breaches of the rules or procedures in respect of those orders;
- Ensuring that arrangements between the Trading Platform and the DMA/SA provider stresses that the provider firm remains responsible to the Trading Platform for all trades using their market participant ID code and that provider firms conduct due diligence on clients to whom they provide DMA/SA;
- Having the right to refuse a participant's request to allow access by a particular firm or institution;
- Having the right to suspend or withdraw the SA and to stop orders from a person trading through SA separately from the orders of the SA provider firm; and
- Having the right to review a member's, participant's or user's internal risk control systems in relation to their DMA and SA clients.

Investment firms who provide DMA/SA must establish policies and procedures to ensure the trading of those clients complies with the rules and procedures of the relevant Trading Platforms. These will include:

- Conducting due diligence on all prospective DMA/SA clients, whether they are based in the EU or not;
- Imposing pre-trade controls which automatically reject orders outside of certain parameters and ensuring that those parameters can only be modified by the DMA/SA provider firm;

- Imposing pre-trade controls which prevent "naked" or "unfiltered" access to Electronic Trading Systems. This is to ensure that a SA client is never able to send an order to a Trading Platform without the order passing through pre-trade controls of the sponsoring firm;
- Identifying and monitoring order flow coming from their own DMA/SA clients and having the ability to immediately halt trading by individual DMA/SA clients.

What do MiFID 2 proposals say on automated trading?

The European Commission's proposals on automated trading go beyond the best practice declarations found in the Guidelines and look to tackle some of the perceived issues raised by high frequency trading. The proposals if implemented would:

- Drive into the regulated space high frequency traders not currently regulated but who have an EU place of business;
- Force EU-regulated investment firms who use trading algorithms to submit them to the scrutiny of EU regulators raising confidentiality concerns and issues of whether regulators are capable of giving adequate feedback;
- Force RMs, MTFs and Organised Trading Facilities (called trading venues) to examine their systems and controls to ensure that their venues can cope with algorithmic trading without the risk of disorderly trading conditions;
- Force some investment firm algorithmic traders into market making roles by requiring them to continue to offer prices at times of market stress;
- Force investment firms who provide clients with direct electronic access to trading venues to assess the suitability of those clients. This may impact non-EU traders who use local firms to give them direct access to EU trading venues.

In addition, the proposed Market Abuse Regulation would outlaw specific types of algorithmic trading that will constitute market abuse.

The MiFID 2 and Market Abuse Regulation legislative processes are ongoing and the proposals are subject to change. Current market expectations are that MiFID 2 and the Market Abuse Regulation will be implemented in or around 2014, although the European Commission will push for earlier implementation dates.

What is the status of the Guidelines

The Guidelines are not formal technical standards or regulations and do not have the force of law. National EU regulators have until the end of February 2012 to decide whether they wish to adopt them as part of their supervisory approach. Any national regulator who decides not to adopt them must explain why and these reasons will be published by ESMA. Because the Guidelines in the main declare best practice we would be surprised if EU national regulators refuse outright to adopt them. Assuming adoption, regulators and financial market participants must make every effort to comply with them. The Guidelines will provide justification for the action of national regulators in this particular area. We expect that any non-compliance with the Guidelines will be used by national regulators to demonstrate breaches of national laws and regulatory requirements by EU RMs, MTFs and EU-regulated investment firms.

When will the Guidelines come into effect?

The Guidelines will come into effect in each EU member state after the relevant national regulatory authorities publish them on their official websites. ESMA expects the Guidelines to be in effect throughout the EU from 1 May 2012.