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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 2 proposals 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, advisory and discretionary portfolio managers with EU head offices or EU places of business;
- 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;
- Firms and funds who 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.

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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.

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 proposals in MiFID 2 to require high frequency traders to adopt quasi-market making roles and bringing 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 Guideline implementation 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 then the risk of a repeat will not disappear. The Guidelines are, however, a first step in the attempt to deal with a serious issue.

## Main Highlights

- EU RMs and MTFs must ensure that their Electronic Trading Systems are well adapted and robust enough to ensure market continuity and regularity.
- EU-regulated MiFID investment firms must ensure the robustness of their Electronic Trading Systems, including their trading algorithms. They should ensure that algorithms work effectively in stressed market conditions and ensure their compliance with market rules and regulatory obligations. Algorithms will need to be tested in a controlled manner in real-time live environments which may hamper the strategies of some high frequency traders.
- EU Trading Platforms will need to impose specific requirements for investment firms who are based outside the EU and are not EU-regulated which are designed to ensure compliance with the Guidelines. 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, and who are therefore unregulated, will also be subject to similar requirements.
- Market operators must have procedures to ensure, and investment firms must promote, fair and orderly trading. They must ensure that their systems prevent market abuse. This will be welcome to buy-side firms who have complained about ping orders, quote stuffing, momentum ignition and layering and spoofing. These complaints have led buy-side firms to seek out dark pools to protect their clients. It remains to be seen whether the Guidelines will lead to more trust in the fairness and the soundness of prices to be found in lit markets.
- Trading platforms that 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. Participants must be responsible for orders passing through their systems under their trading ID code. They should be required to perform due diligence on clients to whom they provide access. Trading platforms should have the right to refuse a participant's request to allow access to a particular firm or institution.

Investment firms who actually provide DMA/SA must comply with additional requirements and in particular impose pre-trade controls which prevent "naked" or "unfiltered" access to Electronic Trading Systems. They will need to separately identify and monitor order flow coming from their own DMA and SA clients.

## 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 EU regulators to show 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 from 1 May 2012.

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For more specific details regarding this subject matter, please click here.