

Response to specific consultation questions

Q1. Do you agree with ESMA that it is appropriate to introduce guidelines already before the review of MiFID covering organisational arrangements for trading platforms and investment firms in relation to highly automated trading, including the provision of DMA/SA?

AFME broadly supports these ESMA guidelines subject to the need for ESMA to be proportionate in its approach and to coordinate closely with the Commission to ensure any changes required to these guidelines, following the MiFID and MAD review, are kept to a minimum as well as also being subject to a thorough cost benefit analysis. Given the likelihood that outcomes following the MiFID review will not be implemented before the end of 2013, we understand ESMA's keenness to address this subject now.

AFME seeks a realistic transitional period to be provided by ESMA for the efficient and effective implementation of these requirements, given potential significant technical and operational modifications that may be necessary to be undertaken by AFME members.

AFME also urges ESMA to make sure that the guidelines are incorporated in a consistent way by national competent authorities in their supervisory practices to avoid implementation discrepancies.

Q2. Do you think that the draft guidelines adequately capture all the relevant points relating to the operation of trading platforms' electronic trading systems?

AFME supports ESMA's approach in setting out high level guidelines and believe they are pitched at broadly the right level, particularly to facilitate flexible and proportionate application. We also hope the high level nature of these guidelines will reduce the likelihood of significant new requirements arising in relation to the points covered in this paper, following the MiFID and MAD reviews and urge ESMA to coordinate closely with the Commission to limit the need for further such modification.

AFME supports robust organisational requirements across all trading venues, whether they are Regulated Markets or MTFs. In addition, we support appropriately calibrated standards for harmonisation of controls at trading venue level.

We believe this guideline adequately captures the key requirements relating to operating an electronic trading system and provides useful clarification regarding aspects of MiFID.

Q3. Are there areas where it would be helpful to have more detail on the organisational requirements applying to trading platforms' electronic trading systems?

We would suggest that ESMA's guidelines provide more details regarding the systems and controls that could be established to prevent and detect market abuse.

Q4. Do you have additional comments on the draft guidelines on organisational requirements for trading platforms' electronic trading systems?

AFME would agree with the requirement for controlling the volume of messages where capacity limits are threatened, providing that these throttle limits are pre-defined and certain (i.e. member obtains connections with a specified bandwidth in terms of maximum messages per second). Dynamic throttling (whereby if the exchange is busy the messages per second on a connection are throttled back) could potentially create or exasperate a disorderly market and hence trigger algorithms to distress.

Q5. Do you think that the draft guidelines adequately capture all the relevant points related to the operation of trading algorithms?

AFME considers that these requirements cover the key points relating to an investment firm operating an electronic trading system and also provide some useful clarifications.

However, AFME believes that the Guidelines do not distinguish between the situation where a firm itself uses algorithms for electronic trading or a firm provides connectivity to a client that is deploying algorithms to access a market electronically, particularly, where electronic connectivity is being provided by a firm to a client that is also regulated in the EU or under an equivalent regulatory system and, as such, has its own obligations to have sound internal governance controls. AFME believes the nature of appropriate governance arrangements should differ in these situations to avoid duplication and to reflect the difference between connectivity providers and the originators of a given algorithm.

AFME supports ESMA's requirement to formalise a Governance Process around the development, deployment and monitoring of electronic and algorithmic trading systems that would involve Compliance and Risk. As regards Compliance, its role in this Governance Process should be clarified and further developed in particular in relation to algorithmic trading as the workings and strategies of algorithms can be very complex and IT intensive. It is thus very important to carefully consider what Compliance will be exactly asked to sign-off as the specific mechanics of an algorithm may really be beyond the remit/knowledge base of Compliance. In this respect, AFME would suggest that Compliance's approval be around the overall controls and processes surrounding new releases of algorithms (for example) and that there are some periodic checks by Compliance to ensure procedures are followed.

Q6. Are there areas where it would be helpful to have more detail in the guidelines applying to the organisational requirements for investment firms' electronic trading systems?

We would request further clarification regarding what comprises '*adequate records*', e.g. retention timeframes etc., to ensure consistent interpretation and implementation of the guidelines across EU Member States and between firms.

In terms of testing, we agree with ESMA that while playing an important role, testing may be limited. In particular, we would like to highlight that real time trading cannot be fully replicated within a test environment and therefore, we would agree with ESMA that firms need to be cautious when operating algorithms.

With respect to ESMA's proposal that investment firms monitor trading on the basis of being as close to real time as possible, we believe even with significant commitment to monitoring technology and staffing, such pre-trade monitoring will still have its limitations.

AFME asks ESMA to consider carefully the implied approach for tackling flash-crash type scenarios especially due to the rapid withdrawal of liquidity from the market and specifically focusing on algorithms. On page 19 of the consultation document, the monitoring section refers to 'ensuring that an algorithm can continue to work effectively in stressed market conditions' and 'not letting an algorithm exit all positions simultaneously'. The former could refer to technical capability and resiliency of the platform the algorithm is running on; the latter could be very dangerous as generally algorithms are designed to halt (and withdraw liquidity) when they get into a distressed status. This may occur for example, when the algorithm or user receives a signal that the market is too volatile or the maximum daily position allowed on the trading desk is reached. Alternatively, the order may be received to shut down the algorithm for the remainder of the day. This would generally happen if the algorithm's parameters move 'out of bounds' and as such either there is a problem with the algorithm itself or most likely there is a dislocation or disorderly market.

In either case, leaving an algorithm working in any way could exasperate the problem and so it makes much more sense that it shuts-down and withdraws immediately from the market. We believe that the aim here should be to prevent a disorderly market in the first place and hence we believe ESMA should focus on guidance around circuit breakers and conformance testing (this is the approach adopted by the SEC and FIA). There are other mechanisms available to assist appropriate levels of liquidity during periods of high activity and volatility.

Q7. Do you have additional comments on the draft guidelines relating to organisational requirements for investment firms' electronic trading systems?

Please refer to our response at Q6 above

Q8. Do the draft guidelines on organisational requirements for trading platforms to promote fair and orderly trading offer a sufficiently comprehensive list of the necessary controls on order entry?

AFME believes that levels of controls employed by trading venues presently are inconsistent and we therefore welcome guideline 3 associated with this question as we believe that it should facilitate greater consistency in this area.

Q9. Are there any areas of the draft guidelines on organisational requirements for trading platforms to promote fair and orderly trading where you believe it would be helpful to have more detail?

AFME considers that there may also be opportunities for more consistency (per Q8 above) through the sharing of best practices which could be facilitated at an EU level by

ESMA. We are aware of the existence of controls at certain exchanges which might usefully be able to be taken up more broadly – for example:

- Liffe has a transaction ratio of approximately 25 transactions per fill. Where this ratio is exceeded, the exchange notifies the client in order that the matter may be addressed. In addition, we believe that fines may be imposed by Liffe in cases of repeated offences.
- Eurex has introduced a three tier system for Non Clearing Members: (1) warnings issued when close to limits, (2) systems being in place (commonly known as “throttling”) to slow down orders and (3) hard limits which halt trading.

Q10. Do you have additional comments on the draft guidelines on organisational requirements for trading platforms to promote fair and orderly trading?

Please refer to our response to Q9 above.

Q11. Do the draft guidelines on organisational requirements for investment firms to promote fair and orderly trading offer a sufficiently comprehensive list of the necessary controls on order entry?

Under the word ‘compliance’, ESMA seems to refer to several controlling functions. AFME believes that monitoring tasks might be performed by compliance or other independent control function staff, according to an individual firm’s organization (e.g. a risk management function might do real time monitoring and escalate to Compliance within a predefined process). We would naturally anticipate the need for compliance professionals to continue to review trading activity as part of a broader monitoring/surveillance role.

AFME recognises the importance of ensuring adequate oversight of information relating to investment firms’ orders and generally supports ESMA’s proposals in this regard. However we would suggest that in terms of over-riding pre-trade controls, it should be sufficient for approval to be granted by risk management or compliance staff, and not necessarily both given their respective responsibilities within firms. Moreover, AFME believes that it may not realistically be possible to have both Risk and Compliance validating each single overriding of pre-trade control.

Such systems of control require senior business management and IT approval prior to being implemented with Compliance and Risk being informed in real time of any changes via email so they can have full knowledge and audit trail.

AFME would also like to raise the matter relating to the requirement that investment firms should automatically block or cancel orders if “the client does not have adequate funds or holdings, or access to, the relevant financial instrument to complete a transaction”. AFME believes that in reality, practicalities will hinder compliance complying with this requirement in a day to day trading environment, especially in the context of DvP trades. For markets which operate a T+3 settlement cycle, it may not be

possible to know at the time of the order whether payment or delivery will be made. AFME therefore believes that this guideline should be amended to reflect the practical realities of operating in a DvP environment.

Q12. Are there any areas of the draft guidelines on organisational requirements for investment firms to promote fair and orderly trading where you believe it would be helpful to have more detail?

As AFME highlights above in response to Q6, AFME seeks clarification over what is meant by '*adequate records*' to ensure consistent interpretation of the guidelines across EU Member States and between firms.

In addition to our response to Q11 above, regarding the requirement that Compliance should monitor orders real time (guideline 4.5), it would perhaps be useful to develop/clarify further the expected role of Compliance versus the real time monitoring of the business.

Q13. Do you have additional comments on the draft guidelines on organisational requirements for investment firms to promote fair and orderly trading?

Please refer to our responses to Q11 and Q12 above.

Q14. Are there any areas of the draft guidelines for trading platforms on organisational requirements for regulated markets and MTFs to prevent market manipulation where it would be useful to have extra detail?

AFME agrees with ESMA's viewpoint that automated trading may present additional challenges in terms of the detection of market abuse. We consider, therefore, it is appropriate for trading venues to have processes in place as outlined in this guideline, as they have a view of all trading undertaken on their venue. Harmonised standard across all trading venues will also limit the opportunity for regulatory arbitrage.

We would also highlight the critical role for regulators in detecting market abuse as they are unique in having a complete view of the activity across all venues. In this respect it would be useful to get further insight on how surveillance at various points (trading venues/investment firms) would fit together at a pan-European level while taking carefully into consideration the regulatory changes to be introduced by the MAD review.

Q15. Do you have additional comments on the draft guidelines on organisational requirements for RMs and MTFs to prevent market manipulation?

Please refer to our response to Q14 above.

Q16. Are there any areas of the draft guidelines on organisational requirements to deal with market manipulation for investment firms where you believe it would be helpful to have more detail?

AFME agrees that investment firms should have arrangements in place to prevent, detect and report market abuse arising from their highly automated trading activities and generally agree with ESMA's proposals. ESMA requirements will likely involve a

significant broadening of monitoring/surveillance activities for Business, IT, Risk and Compliance and therefore necessitate changes to systems, controls and associated procedures and processes. Accordingly, we ask that ESMA considers and allows a reasonable timescale for implementation of these monitoring/surveillance requirements.

We also see benefit in regulators performing benchmarking/thematic reviews in order to identify industry inconsistencies, highlight best practices with regard to monitoring expectations and share that information with firms.

Q17. Do you have additional comments on the draft guidelines relating to organisational requirements to deal with market manipulation for investment firms?

As a matter of principle, investment firms can only monitor orders that they agree to execute. Considering that clients execute orders via numerous investment firms, the key level of surveillance to get the full picture of client trading activity will need to be at “trading venues” level and through consolidated Transaction Reporting at the supervisory level.

Q18. Do the draft guidelines on organisational requirements for trading platforms whose members/participants or users offer DMA/SA deal adequately with the differences between DMA and SA?

AFME believes that it is important to highlight that for DMA and controlled SA market access (the latter being where the intermediary/exchange member allows trading by his client outside of the intermediary’s own infrastructure but within a strict prescribed real time controls environment) the risks are considered broadly similar. Alternatively, naked SA (which AFME does not generally support) is where risks may be considered higher due to those strict controls not typically being in place.

Q19. Are there any areas of the draft guidelines on organisational requirements for trading platforms whose members/participants or users offer DMA/SA where you believe it would be helpful to have more detail?

Please refer to our response to Q18 above.

Guideline 7.2 second indent requires member/participant or user to have adequate systems and controls. AFME would ask to clarify/give details on the meaning of “adequate”.

Q20. Do you have additional comments on the draft guidelines relating to organisational requirements for trading platforms whose members/participants or users provide DMA/SA?

Please refer to our response to Q18 above.

Q21. Do the draft guidelines on organisational requirements for investment firms providing DMA/SA deal adequately with the differences between DMA and SA?

Please refer to our response to Q18 above.

Q22. Are there any areas of the draft guidelines on organisational requirements for investment firms providing DMA/SA where you believe it would be helpful to have more detail?

Please refer to our response to Q18 above.

Q23: Do you believe that there is sufficient consistency between the draft guidelines on organisational requirements for investment firms providing DMA/SA and the SEC's Rule 15c3-5 to provide an effective framework for tackling relevant risks in cross-border activity and without imposing excessive costs on groups active in both the EEA and the US?

AFME encourages regulators to take a consistent approach to pre-trade and post-trade monitoring wherever possible. We are broadly supportive of SEC's rules and regulations in relation to managing risk in highly automated trading and urge regulatory authorities to seek global standards wherever it is practical and permissible to do so. As many firms provide access to global markets, a consistent international regulatory approach would encourage market confidence and stability as well as benefitting market users and systems providers.

With respect to cost-benefit analysis, AFME highlights our concerns that actual implementation costs are often significantly under-estimated. By way of example, the SEC estimated the operational cost of implementing Rule 15c3-5 for broker-dealers (referred to by ESMA on page 58, footnote 35) was \$167,904 for staff and \$102,500 for hardware per firm. However, data gathered from AFME members undertaking relevant US business suggests that actual costs of implementation of Rule 15c3 (primarily costs for software) were considerably higher.

Q24. Do you have additional comments on the draft guidelines on organisational requirements for investment firms providing DMA/SA?

Please refer to our response to Q23 above.

Q25. Does the explanatory text provided in addition to the guidelines (see Annex VII to this CP) help market participants to better understand the purpose and meaning of the guidelines? Should it therefore be retained in the final set of guidelines?

AFME agrees that whilst retaining the explanatory text in the guidelines is helpful, this should not form part of the formal guidance.