



ESMA
103 Rue de Grenelle
75007 Paris
France

Deutsche Bank AG
Andrew Procter
Government & Regulatory
Affairs
Winchester House
1 Great Winchester Street
London EC2N 2DB

Tel: +44 (0) 20 7541 0716
Tillie.Rijk@db.com

4 October 2011

Re: Consultation paper on “Guidelines on systems and controls in a highly automated trading environment for trading platforms, investment firms and competent authorities”

Dear Sirs,

We welcome the opportunity to comment on ESMA's consultation paper on guidelines and controls in a highly automated trading environment. We support further clarity on these issues and advocate more harmonisation of risk control methodologies at trade venue level across the EU.

We support the proposed guidelines on organisational requirements for investment firms and note that to a large extent these reflecting existing market practice. However, the promotion of fair and orderly trading is – and can only be – an effort of both market participants and trading venues. When monitoring market abuse and manipulation, for example, firms are dependent on good quality data from trading venues. While firms can monitor trades going through their own systems, it should be the responsibility of trading venues to carry out trading surveillance in the wider market context.

We strongly support more harmonised minimum risk control methodologies at the level of trading venues. Trading venues tend to set individual risk controls which require firms to implement different controls for different venues. This creates uncertainty at the firm level, unnecessary cost and complexity and risks to the integrity and stability of the market.

Finally, we do not believe a case has been made for the separate regulation of market abuse in the areas of high frequency or algorithmic trading. In either case, abuse trading is possible but the risk is no greater than in many other areas and the existing general laws are sufficient to deal with the risk. Matters peculiar to high frequency or a logarithmic trading should be dealt with by organisational and governance requirements as proposed in this consultation paper.

Please find our detailed responses to your question below. We trust these comments are helpful.

Yours sincerely,

A blue ink signature, likely of Andrew Procter, consisting of a stylized 'A' followed by a horizontal line.

Andrew Procter
Global Head of Government & Regulatory Affairs



- 1. 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?**

We understand ESMA's thinking that in the absence of European legislation guidelines would be helpful and agree that a harmonised European approach would contribute to the integrity of the European markets. However, we caution against introducing any substantial new guidelines before the outcome of the MiFID review becomes clear. Guidelines should focus on the those issues where ESMA deems they are proportionate and, given the short time they will be relevant in light of the MiFID review, justified by an urgent need.

In addition, the successful implementation of some market wide risk controls are dependent on changes in the European market structure which will be introduced after the launch of the revised MiFID. For example, guidelines on circuit breakers may be premature as they will not work properly without a consolidated tape to ensure that all price information is equal across the market.

Guideline 1

- 2. Do you think that the draft guidelines adequately capture all the relevant points relating to the operation of trading platforms' electronic trading systems?**
- 3. Are there areas where it would be helpful to have more detail on the organisational requirements applying to trading platforms' electronic trading systems?**
- 4. Do you have additional comments on the draft guidelines on organisational requirements for trading platforms' electronic trading systems?**

The guidelines reflect the obligation of trading platforms to foster orderly markets. We note that exchanges and other trading platforms are crucial to establishing controls and making sure that they continue to work. While we fully agree that firms should have appropriate controls in place for high frequency trading and algorithms, firms' ability to do so depends for a large part on clear and harmonised risk controls at the exchange level, as well as exchanges' willingness to feed back trade data to firms to enable them to carry out monitoring activities.

As data vendors are an intrinsic part of markets infrastructure but not in fact regulated entities, more responsibility should be placed on exchanges to carry out due diligence of vendors before they approve them. Additionally, we would suggest a requirement for an annual review of the vendor and its products so that exchanges have assurance that vendors are still capable to adequately deliver the necessary services.

Guideline 2

- 5. Do you think that the draft guidelines adequately capture all the relevant points related to the operation of trading algorithms?**
- 6. 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?**
- 7. Do you have additional comments on the draft guidelines relating to organisational requirements for investment firms' electronic trading systems?**



In general, we feel the guidelines appropriately cover the operation of trading algorithms. We note that within DB the governance process is based on specific committees that gather on a weekly and monthly basis. An important element of these committees is to determine whether appropriate risk checks are in place. In addition both new platforms and significant changes to the platforms are an intrinsic part of our New Product Approval process.

Detailed guidelines 2 second bullet: A “normal activity/maximum IT capacity” is extremely difficult to calculate for specific circumstances and instruments. Therefore, rather than put in place a prescriptive measure, it may be advisable to include the need to have sufficient capacity of electronic trading systems with sufficient capacity as a statement of principle in the requirements for business continuity arrangements.

Detailed guidelines 2 seventh bullet: It is not clear whether this addresses the monitoring of the technical performance of the systems or the monitoring of trades that are put through the systems. In the latter case, we note that while we have real time controls in place for - for example – “fat finger” trades, it is important to keep in mind that Deutsche Bank is only one market participant and does not see activity across the entire marketplace. Our reviews occur as close to real time as possible in order to take trade patterns into account.

Guideline 3

- 8. 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 to order entry?**
- 9. 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?**
- 10. Do you have additional comments on the draft guidelines on organisational requirements for trading platforms to promote fair and orderly trading?**

Pre-trade controls

We support the implementation of minimum risk control methodologies for trading platforms to ensure that all parties adhere to minimum standards and that adequate market safeguards are in place. Under no circumstances should it be possible to gain competitive advantage by tolerating insufficient validation controls.

Common minimum risk control methodologies for trading platforms will increase transparency and clarity for market participants, and will keep down costs for market participants who – at this time – have to implement specific risk controls per exchange. Disparate requirements add an unnecessary complexity to those firms who provide trading platforms to multiple global venues.

Circuit breakers

We strongly encourage the harmonisation of volatility rules across trading platforms. Markets where both trading halt rules and limit up/limit down rules are in place – as is the case across the European markets - run the risk of allowing liquidity to become “trapped” on a trading venue. This is clearly illustrated by the joint SEC-CFTC Report on the 6 May “flash crash” which concluded that there was potential for liquidity to become trapped on the NYSE through its “Liquidity Replenishment Point (LRP)”. The LRP was only in place on the New York Stock Exchange and NASDAQ and caused trades to flood away from these exchanges to other venues thus becoming a major catalyst of the decline in prices.



We support limit-up/limit-down systems. By creating a system where trades may occur within a band and where this band may be adjusted in case of “real” price moves, more crude measures such as suspending all trading in a stock would be unnecessary.

A limit-up/limit-down mechanism should meet the following requirements:

- It should take into account cross product/cross market hedging.
- The time priority of blocked orders should be maintained.
- It should not be possible to cancel trades once executed as this would create uncertainty on the markets.

The design of circuit breakers and/or limit-up/limit-down systems, should take into account the inherent conflicts of interests in systems that permit certain exchange members to gain more market share. Any system should guarantee a level playing field for all market participants.

We would welcome a wider dialogue between regulators, exchanges and investment firms on the specific controls that should be put in place.

Listed derivatives

Controls at firm level

With regard to controls at the level of the firm, we would advocate the introduction of simple and robust risk controls. For example, for listed derivatives trading limits should be applied by 'account', not by 'trader'. If limits are applied by trader a firm would have to entitle the trader with the greatest of all the limits of all the accounts they are allowed to trade. The trader could then use these 'large' limits on the smallest of the accounts they can trade. If, however, entitlements are applied by account, any trader trading that account is governed by the same set of limits relative to the size of the account. Such a simple, robust risk management methodology is easy to implement.

We would suggest the following. Members/participants should apply limits (by account and by product) to:

- Futures Outright (i.e. not hedged) orders
- Futures Strategy orders
- Options Outright orders
- Options Strategy orders

A single position limit that covers both outright and strategies should be applied to futures and options.

Controls at the level of trading platforms

Trading platforms should put in place the following checks:

- A buy order should be rejected if placed more than x ticks (or %) higher than the offered price / fair value
- A sell order should be rejected if placed more than x ticks (or %) lower than the bid price / fair value

Reasons why this control should be put in place by the platform and not the member or participant are related to the specific characteristics of futures and options markets:



- Many contracts have a price of zero. A percentage range around zero is not mathematically possible. For example, an equity requirement to reject an order x% away from the market is not appropriate for option strategies where zero is a valid price and, in the case of infrequently traded contracts, requires a model to calculate and maintain the fair price.
- Many contracts do not have a bid / ask / last price and/or a last price at a level that reflects the current market;

Detailed guidelines 2 first bullet: In order to prevent conflicts of interest when “busting” trades, we would add to the sentence: “as per pre-defined erroneous order rules of the Regulated Market or MTF”.

Guideline 4

- 11. 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?**
- 12. 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?**
- 13. Do you have additional comments on the draft guidelines on organisational requirements for investment firms to promote fair and orderly trading?**

Detailed guidelines 2 second bullet point - It is implied that a firm has a real time view of a client's position. However, while firms tend to have controls in place to ensure that a client only trades in the instruments that are part of the client agreement, we do not have oversight of a client's full financial position or custody holdings with other firms. We noted the discussion on the point at the open hearing on this consultation paper and look forward to seeing the revised text on this.

Detailed guidelines 2 third bullet point – Controls are in place to ensure that a client only trades the instruments that are part of the client agreement. However, it is not clear whether ESMA also refers to restricted lists. Should this be the case, then we note that we would not have access to another firm's restricted list. We see it as the obligation of the client firm to enforce such a list. Revision of this text was discussed at the open hearing.

Detailed guidelines 5 – ESMA indicates that compliance staff should have close to real time access to orders. While some risk functions would have such access, for example to remedy a “fat finger” trade, it is generally not a task of the compliance function to monitor trades in real time. Rather, Compliance looks at patterns in trading – in the context of the wider market – to ensure no manipulative or abusive actions have taken place.

Detailed guidelines 6 and 7 – One of a firm's most significant operational risks is its ability to deal with under capacity of the electronic trading systems. While we agree that governance systems are important in this respect, we would also point to the important role of exchanges: Investment firms buy messaging capacity from exchanges. While firms will try to judge what capacity they need to the best of their ability, ultimately exchanges control messaging arrangements. Therefore, the exchanges should have the responsibility to inform firms when they come close to reaching full capacity.



Guideline 5

- 14 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?**
- 15 Do you have additional comments on the draft guidelines on organisational requirements for trading platforms to promote fair and orderly trading?**

The proposed requirements for trading platforms seem to differ from those for investment firms. For example, in the detailed guidelines, 2 – third bullet – investment firms are required to specifically take into account orders submitted, modified and cancelled as well as transactions executed. In order to come to a harmonised and transparent risk framework for highly automated environments, we feel that requirements for firms and exchanges should be as similar as possible.

Additionally, the paper perhaps over states the risk of market manipulation and market abuse through automated trading. We believe existing laws are generally adequate to address the risk and that any review should be undertaken in the context of the review of the Market Abuse Directive.

Specifically with regard to layering and spoofing we note that these are practices that are not limited to high frequency trading but take place in “traditional” trading as well. However, the monitoring of spoofing does pose difficulties: As we noted above, a single broker normally does not have a view of all of a client’s orders and if a client is attempting to spoof/layer through multiple brokers, neither the exchange nor the brokers will be aware of this.

Guideline 6

- 16 Are there any areas of the draft guidelines of organisational requirements to deal with market manipulation for investment firms where you believe it would be helpful to have more detail?**
- 17 Do you have additional comments on the draft guidelines relating to organisational requirements to deal with market manipulation for investment firms?**

Please see our response to questions 14 and 15.

Monitoring of activities on platforms and by firms should be seen as complimentary. Investment firms often lack sufficient market data to place trades in a wider market context. An example of something that would be difficult for investment firms to monitor is “momentum ignition” (paragraph 38). Therefore, a clear responsibility should be placed on trading venues to carry out the “holistic” trading surveillance.

Detailed guidelines 2 fourth bullet point: The paper mentions “adequate arrangements to identify transactions and orders that require a Suspicious Transaction Report” (STR). However, under the existing rules on STRs firms are not required to report orders.



Guideline 7

- 18 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?**
- 19 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?**
- 20 Do you have additional comments on the draft guidelines relating to organisational requirements for trading platforms whose members/participants or users provide DMA/SA?**

In addition to the sources quoted on page 33, we also refer to the “Guidance on Managing Risks of Direct Market Access” of the Futures and Options Association which, among other things, sets out pre-trade controls for DMA.

Detailed guidelines 2 last bullet point: We agree that trading platforms should be able to cancel a DMA order separately from orders of the member sponsoring that access. We would add that the exchange or trading platform should simultaneously alert the sponsoring firm that an order has been cancelled, so that the firm can re-evaluate its clients’ integrity and trading capability.

Additionally, we would add to the detailed guidelines a general requirement for trading platforms to have in place transparent procedures for access and due diligence of members or participants that apply for the provision of direct market access services. This would ensure a level playing field for all members/participants.

Guideline 8

- 21 Do the draft guidelines or organisational requirements for investment firms providing DMA/SA deal adequately with the differences between DMA and SA?**
- 22 Are there any areas of the draft guidelines or organisational requirements for investment firms providing DMA/SA where you believe it would be helpful to have more detail?**
- 23 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?**
- 24 Do you have additional comments on the draft guidelines on organisational requirements for investment firms providing DMA/SA?**

Detailed guidelines 2 third and fourth bullet point – We refer to our comments on guidelines 5 and 6: While firms are able to monitor orders of individual clients, trading platforms should have the responsibility for holistic trade surveillance.

Detailed guidelines 2 seventh bullet point - In practice trading platforms provide firms with real time “drop copies” of client orders entered via sponsored access, which are then used to monitor trades.