

HSBC CONTINENTAL EUROPE MSS response to ESMA CP on MiFID II algo trading

At HSBC Markets & Securities Services (HSBC MSS) our purpose is to open up opportunities for clients through our world-class capabilities and our focused global network that connects East and West.

We serve clients across HSBC – from Wealth and Personal Banking customers through to SMEs, Middle Market Enterprises, Corporates, Financial Institutions and Public Entities. We enable them to unlock investment opportunities, access financial markets and liquidity, manage risk and transact across borders. We do this through our expertise in Trading, Financing and Securities Services. Our proposition is underpinned by our digital, data and electronic trading capabilities, enabling seamless transactions and access to business intelligence, while ensuring operational resilience. We are embracing emerging technologies to open new opportunities for our clients.

HSBC MSS has been an active participant in the responses provided by AMAFI, AFME and FIA. In addition to supporting those responses, HSBC Continental Europe wish to highlight the following points and make the following specific responses. We would be pleased to join any further discussion or working groups to assist ESMA in its work on this topic.

Q1: What is your overall assessment of the MiFID II framework for algorithmic trading, HFT and DEA?

HSBC Continental Europe believes that the MiFID II framework for algorithmic trading, HFT and DEA addressed the main identified implications of the increased use and evolution of trading technology and that, bearing in mind the massive changes that are on-going particularly in the ESG field, any modifications of the existing regime should be carefully analysed to ensure that they are really necessary and have a very clear positive cost/ benefit outcome.

Q2: In your views, are there risks other than the one mentioned in MiFID II or impacts on market structure developments due to market electrification/ algorithmic trading that would deserve further regulatory attention? Please elaborate.

Firms continue to experience regular IT and system outages on trading venues, in particular on venues which are deemed the most relevant markets under MiFID. This has a direct impact on the ability of investment firms to provide continuous service to our clients. We consider that the requirements on trading venue operators to ensure business continuity could usefully be strengthened in order to provide better resiliency for European investment activity. This is particularly the case in equities markets where competition and asset fungibility should ensure such resiliency exists.

Q3: Do you consider that the potential risks attached to algorithmic trading should also be given consideration in other trading areas? Please elaborate.

We consider that the subject of this consultation has relevance to and may be impacted by potential developments in other areas of regulation (for instance on operational resilience), and therefore recommend that all such developments are examined as a whole as well as individually, to ensure that a consistent approach is taken across the board.

Q4: Do you agree with this analysis? If not, please explain why.

We consider that it would be more appropriate to apply the definition of algorithmic trading only to where a firm is trading directly on the market. In cases where any entity is trading via DEA, rules can be, and are, applied to it by the exchange member (the DEA provider), pass through the controls of

the DEA provider, and can be enforced by them. As further detailed in our response to Q10 below, taking this approach will also ensure a level playing field between EU and non-EU DEA clients.

Q5: Did you encounter any specific issue with the definition of HFT? Do you consider that the definition should be amended? Do you have any suggestion to replace the high message intraday rates with other criteria or amend the thresholds currently set in Level 2? Please elaborate and provide data supporting your response where available.

Issues arise in the definition of HFT, as the drafting and criteria catch a much wider range of activity than we believe were intended by the co-legislators. Whilst we note that at present the result of being deemed HFT is the requirement to satisfy enhanced record-keeping requirements for in-scope messages (to which we have no objection albeit the data storage requirements are significant), we remain concerned that where a firm is deemed HFT, there could be further consequences under other legislation or regulation in future resulting in obligations or restrictions that are not appropriate or workable.

HSBC MSS trading activity is focussed on servicing our clients and managing the risks that arise from those client services.

In that capacity we act as primary dealer in certain government securities, and as market maker. We may be a market maker pursuant to a market making agreement with a trading venue operator, or pursuant to a bilateral contract with an issuer client of the bank where we undertake to provide liquidity in that issuer's securities for a pre-determined period and subject to a pre-determined set of parameters. In each such role, we submit two-way quotes on a continuous basis to the relevant market or trading venue(s). Based on the drafting of the HFT definition in MiFID II art. 4(1)(40) the automated messages sent in relation to these obligations must be taken into account in determining whether the relevant HSBC entity is considered HFT.

Whilst recital 61 refers to market making, we believe that HFT should be understood as an entity that uses sophisticated technology to transact in the manner described in recital 61, i.e. "short time-frame for establishing and liquidating positions, high daily portfolio turnover, high order-to-trade ratio intraday and ending the trading at or close to a flat position." We think that market making is referred to in this recital as an example of how two-way price streaming methodologies can be used by high frequency traders as a trading strategy. We do not believe that the co-legislators intended that a firm should be considered HFT simply as a result of its client facilitation and liquidity provision activities even in the absence of any trading behaviour of the sort described in recital 61. Clarifying this position would ensure that the HFT regime captures accurately the firms at which it is targeted.

Q9: Do you agree with ESMA's proposal? If so, do you consider that the requirements considered above relevant? Should there be additional ones? If you disagree with ESMA's proposal, please explain why.

HSBC Continental Europe (and more broadly the global MSS business line) does not agree with ESMA's proposal. We do consider that it is appropriate for firms acting as SIs to be required to apply governance, testing and appropriate risk controls to the algorithms that they use for quote generation, with the purpose that the quotes displayed, streamed, or sent to counterparties or clients are not a source of risk for the SI itself and/or a source of confusion, disruption, or potential chain reactions in the wider market. We believe that the MiFID II organisational requirements have the effect of requiring firms to implement such arrangements.

We further believe it is important to distinguish between the quoting activity that SIs carry out and the activity that takes place on trading venues, as SIs are not trading venues. As ESMA highlights, the potential risks attached to algorithmic trading and potential damaging consequences to orderly markets are more salient with respect to multilateral trading where multiple buying and selling interests may interact.

That said, should ESMA determine that specific provision is needed, we do not agree that this should be achieved by amending the Level 1 definition of algorithmic trading. As well as being used to determine when firms must apply controls to relevant systems and processes the term is used in the context of HFT requirements and in the regulatory perimeter requirements in MiFID II article 2. We perceive that there could be unintended impacts on these concepts and requirements if SIs are included in the article 4(1)(39) definition.

Furthermore, the way that SIs operate can differ between asset classes and it is important to ensure that any requirements are capable of adaptation to the relevant asset class to avoid disruption for clients interacting with SIs. As such, any legislative provision that would apply some of the MiFID II article 17 requirements to SIs would need careful drafting. For example, requirements such as conformance testing and pre-trade controls are not applicable to quotes issued by an SI.

Q10: Do you agree with ESMA's proposals above? Please elaborate.

We agree with ESMA's analysis there would appear to be insufficient benefit to maintain an authorisation requirement for EU firms merely because they are accessing trading venues via DEA. As investment firms providing DEA are already authorised in the Union, all applicable conduct requirements can be satisfied through the supervision of the investment firms providing DEA.

It is also imperative international clients are able to access European trading venues through a DEA channel, without any doubt as to whether this requires licencing in the EU. International access to European trading venues allows for higher concentration of liquidity to coalesce on European markets and is therefore beneficial to European competitiveness. We agree that the proposal to remove the obligation on DEA clients to be authorised as investment firms would clarify this position as well as ensuring an equal treatment of EU and non-EU firms.

We are concerned that ESMA's proposal to introduce a requirement for third-country firms to be authorised as an investment firm when they qualify as an HFT firm on an EU trading venue could have a negative impact on liquidity on EU trading venues. As noted in our response to q5 above, the present definition and scope of HFT captures a firms that are simply conducting client-servicing and liquidity-provision activities. We also note that there is presently no EU-wide authorisation or registration regime for non-EU firms with the result that an entity would likely need to see authorisation in multiple EU countries – requiring some sort of presence in each. If the HFT definition is not clarified then such an authorisation requirement could have the effect of forcing a number of market participants away from EU trading venues, taking their client transactions and liquidity provision with them.

Q15: What is your view on clarifying the definition of algorithmic trading? If you deem it beneficial to refine the definition and account for further types of algorithms or algorithmic trading strategies, please provide your suggestion as well as underlying rationale.

We consider that the definition of algorithmic trading is now well understood and has been well implemented by firms. We think the MiFID II algo regime has broadly worked well and we see no need for changes to the definition.

Should ESMA consider that changes are required, we urge ESMA to note that algorithmic trading is a complex area which has a number of significant differences between asset classes and which is constantly evolving. Any legislative changes should be the subject of detailed liaison with market stakeholders in order to ensure that those changes are workable.

Q36: Do you believe any initiative should be put forward to ensure there is more continuity on trading in case of an outage on the main market, e.g. by requiring algo traders to use more than one reference data point?

We consider it is important to address the current situation whereby essentially all trading stops in the event of a primary market outage. Ideally, the market will be able to develop a solution with the assistance of regulators where needed to ensure a robust process is put in place.

Q37: Do you agree with the view that the tick size regime had overall a positive effect on market depth and transaction costs?

The original intention of the tick size regime was to ensure that orderly and transparent trading takes place on trading venues through promoting effective formation of prices on displayed order books while also maintaining a reasonable depth of liquidity and allowing spreads to fluctuate appropriately. We fully support this intended outcome.

We strongly believe that for trades of all sizes, mid-point should be a valid execution price and that firms should be able to trade at half tick, regardless of whether the activity takes place on a trading venue or SI. This allows for a fair execution price between counterparties and avoids scenarios where trading venues or SIs are forced to preference one side of the trade.

We note that that Europe is a global outlier in preventing execution at mid-point, putting EU firms at a distinct disadvantage and ultimately undermining best execution and EU competitiveness.

Q52: What are your views on the relative timing of private fill confirmations and public trade messages? If you are a trading venue, please provide in your answer an explanation of the model you have in place.

When HSBC MSS provides to a client a price on a trade, the price is calculated taking into account the liquidity in the relevant market(s) and the firm's consequent ability to manage the risk arising from the trade should the client wish to trade on that price. This methodology generally assumes that HSBC MSS will receive a private fill notice prior to the release of the public trade message, and therefore will be able to manage at least part of its risk position prior to the market reacting to the trade. We note that risk is not always managed on a one-for-one trade basis and a number of transactions may be entered into in relation to a single client trade or in relation to a portfolio of client trades.

We are concerned that if investment firms and clients do not receive confirmation of their trades milliseconds before the market, firms may be put at a significant disadvantage in terms of being able to adequately manage their risk prior to the market reacting. If a technologically advanced HFT is informed publicly and faster thanks to its low latency than the participant who was filled and is slower receiving the information, the transparency principle potentially defeats the risk integrity of the market where the HFT would know in advance of the position of the other participant who doesn't know it yet. In other terms, there could be unintended consequences for clients that do not use HFT mechanisms, as HFT market participants would in effect receive information about a client's market position prior the client receiving such information.

We are strongly supportive of ESMA's desire to further research the issues raised in section 6.4.2 of the CP prior to proposing any potential rulemaking in this area. We would encourage ESMA to engage with the industry in its research process and to discuss findings.

Q54: Do you think there should be any legislative amendments or policy measures in respect of these feed dynamics?

We believe that, as always, any legislative amendment should be very carefully analysed before being tabled in order to avoid unwanted effects. We struggle to see the potential benefits of a measure that would aim at prioritising public over private messages, while we clearly see a number of risks inherent in such an approach.

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