

PRESS RELEASE

ESMA consults on systems and controls for highly automated trading

ESMA publishes a consultation paper (ESMA/2011/224) today setting out its proposals for detailed guidelines for trading platforms, investment firms and competent authorities to address challenges of a highly automated trading environment, of which high frequency trading (HFT) is an important part. The guidelines seek to clarify the obligations of trading platforms and investment firms under the existing EU legislative framework. ESMA believes that the proposed guidelines contribute to the efficiency, orderly functioning and resilience of trading in a highly automated environment.

Secondary trading in financial instruments carries a number of risks, such as operational, credit and market risks as well as risks of abusive behaviour that can threaten the regulatory objectives of investor protection, fair and orderly trading, efficient price formation, financial stability and prevention of behaviour undermining market integrity. These risks are inherent to trading and also exist when trading is done on a person-to-person basis or over the telephone. However, in a highly automated trading environment, the organisational arrangements required by trading platforms and investment firms should be tailored to the scale, sophistication and speed of the trading activity that is now taking place and should keep up with the challenges posed to regulatory objectives.

Steven Maijoor, Chair of ESMA, said:

“Clarification of the organisational arrangements which competent authorities can expect from regulated markets, multilateral trading facilities and investment firms to cope with the particular challenges of a highly automated trading environment is an essential step in providing a harmonised supervisory approach in this area. Technological innovation has enabled investors to monitor prices in real time and to submit orders electronically. It has also facilitated trading efficiencies, simplified settlement processes and created new business opportunities for investment firms. A common interpretation of the existing requirements in MiFID will ensure that safeguards in relation to electronic trading systems, fair and orderly trading, direct market access and sponsored access; as well as market abuse will be applied in a homogenous manner and that increased competition in a highly automated trading environment will not lead to an uneven playing field.”

The proposed guidelines are part of extensive work undertaken by ESMA in the area of micro-structural issues and highly automated trading. This includes, for instance, a review of academic literature on the effects of HFT; targeted fact-findings with trading platforms, HFT firms and investment firms providing direct market access/sponsored access; an inquiry with buy-side participants about the impact of HFT on market quality; a roundtable discussion with market participants; and the identification of issues related to the market micro-structure or highly automated trading which would need legislative amendments to be adequately addressed.

The proposals on the clarification of obligations of trading platforms and investment firms under the existing EU legislative framework published in ESMA’s consultation paper (CP) today, addresses broadly four areas. In each area, the guidelines cover separate standards for organisational requirements with



respect to a highly automated trading environment for trading platforms on the one hand, and investment firms on the other. These can be summarised as follows:

1. Electronic trading systems

In complying with their overarching obligations in respect to their electronic trading systems, it is proposed that trading platforms should have regard to several key issues. These include:

- clear and formalised procedures for the development, procurement and monitoring of electronic trading systems;
- resilient and robust systems, well adapted to the business that takes place through them (including the flow of message traffic), and effective business continuity arrangements;
- a testing phase prior to the electronic trading system or updates thereof being deployed;
- staff with necessary up-to-date skills and expertise to run the electronic trading systems;
- periodic review and evaluation of procedures and arrangements, including the electronic trading systems themselves, with some degree of independence;
- adequate records, including, for example, information about key decisions, system properties, testing methodologies, test results and periodic reviews;
- appropriate reporting to competent authorities of significant risks to the sound operation of the electronic trading systems.

Most of these points are also relevant to the electronic trading systems of investment firms. Main additional guidelines relate to trading algorithms used by investment firms.

2. Fair and orderly trading

In the context of the challenges of trading in a highly automated environment, ESMA's guidelines focus on the aspect of fair and orderly trading that relates to the controls that investment firms should have and that trading platforms need to impose on their members/participants and users.

The guidelines proposed for investment firms are to promote fair and orderly trading include organisational requirements to deal with erroneous order entry, risk management and overriding pre-trade controls.

For trading platforms, the guidelines cover issues such as pre-trade controls, the possibility to limit the number of orders which each member/participant or user can send to the trading platform; conformance tests to ensure that members/participants' or users' IT systems are compatible with the trading platforms' electronic trading systems; automatic mechanisms to constrain trading or to halt trading in a specific financial instrument or more widely in response to significant variations in price to prevent trading becoming disorderly; undertaking adequate due diligence of the member/participant or user before accepting their market access and the ability to check their respective controls and arrangements afterwards; setting requirements governing the knowledge of employees of members/participants or users and keeping adequate records of their policies and procedures to ensure fair and orderly markets.

3. Preventing market abuse and in particular market manipulation

ESMA expects that trading platforms' rules and procedures are designed to prevent, identify and report instances of possible market abuse and that they should at least include arrangements that are proportionate to the nature, size and scale of the business done through the trading platform. Furthermore, trading platforms need to monitor orders and transactions with the aim of flagging possible instances of conduct

that might involve market abuse and in particular market manipulation for follow-up investigation. These systems will need to be subject to frequent review to ensure their continued adequacy in times of higher volumes of information. In addition, employing staff with appropriate knowledge about legislative prohibitions and trading strategies is vital to follow-up information provided by automatic alerts. The proposals would also require the reporting of possible instances of market abuse to competent authorities without delay. The trading platforms record keeping should also be of a high enough standard to allow for effective audit trails regarding how each alert is dealt with.

As for investment firms engaging in highly automated trading, the proposed guidelines stress that their policies and procedures should include similar arrangements for monitoring, staff and records. In relation to their obligation to report suspicious transactions, the guidelines stress that, given the nature of highly automated trading, these reports should be extended to orders entered, modified or cancelled, even if they did not lead to a transaction.

4. Direct market access and sponsored access

The increasing sophistication of trading technologies enables firms to access markets and place orders with greater independence, speed and reduced cost. Direct market access (DMA) and sponsored access (SA) offer market participants that are not members/participants or users of regulated markets (RMs) or multilateral trading facilities (MTFs), a more direct or independent route to the market than conventional trading through an intermediary, and in doing so, provide latency advantages and trading anonymity.

However, there are certain risks arising from DMA/SA arrangements. These include the risks that the client's trading breaches a trading platform's operating rules and the DMA/SA provider's respective responsibility; an increased risk that market abuse be disguised by 'hiding' behind an intermediary's member identification; credit and reputational risk to the investment firm; as well as, a risk of a market-wide disruption depending on the scale of the business undertaken by the DMA/SA client.

The proposed guidelines therefore cover organisational requirements for investment firms and trading platforms targeted at these kinds of risks. Generally, the DMA/SA provider firms should be mindful of their responsibility for all trades executed under their market participant IDs. This responsibility should govern their approach towards assessing potential DMA/SA clients and the monitoring of their trading activity. For a robust framework to mitigate the risks, controls need to operate on a pre-trade and post-trade basis. And of course, risk controls needs to be monitored on an ongoing basis.

On this basis, investment firms offering DMA/SA services would therefore, for example, need to assess prospective DMA/SA clients in accordance with predefined criteria, taking into account the potential impact of the DMA/SA client's trading strategy, the client's historical patterns of trading on the relevant trading platforms and the wider market, and its disciplinary history with competent authorities and trading platforms.

Under the proposed guidelines, they would also need to apply pre-trade controls to the trading of DMA/SA clients which stop automatically any order from a DMA/SA client either compromising the DMA/SA provider firm's risk appetite or the credit thresholds of client. Whereas in the case of DMA this can be done at the firm level when the order passes through its systems, for SA this would need to be done at the trading platform level. It is therefore important that DMA/SA firms, wherever they source their pre-trade controls, be it a third party vendor, their own proprietary controls, or controls offered by the trading platform, have the in-built and automatic ability to cancel a trade, should the trade pose a risk. On a post-trade level, the guidelines propose that a DMA/SA provider firms should at least monitor trades using



real-time copied feeds of their DMA/SA clients' activities and using client IDs to monitor and review their DMA/SA clients' trading activity. DMA/SA firms should also have the post-trade measure to terminate a DMA/SA client's access to the order book.

Corresponding to DMA/SA providers' obligations, trading platforms should, for example, establish clear agreements about the responsibility of the DMA/SA provider for all trades under its member/participant ID, and require that the firm providing DMA/SA services have adequate systems to minimise the risks of their clients disrupting orderly trading or participating in market abuse activities. However, where necessary, trading platforms should also be able to carry out a review of members'/participants' or users' internal risk control systems. They should also retain the right to decide who is able to access their market. In the case of prospective SA clients connecting directly to the trading platform without passing their orders through the sponsoring firm's order management systems, a trading platform should refuse or withdraw access if it is not satisfied that the SA client acts in conformity with the rules and procedures for fair and orderly trading. They should also have the ability to distinguish and stop orders from persons trading through SA separately from their members by assigning unique customer IDs to clients that are accessing their market through SA.

In addition to these four areas covered by the guidelines, ESMA would also like to draw stakeholders' attention to the information included in the annexes to the CP which cover, amongst other things, a cost-benefit analysis of the draft guidelines, a review of academic evidence on the effects of high frequency trading and algorithmic trading on market quality, as well as summaries of the responses to CESR's Call for Evidence on micro-structural issues and of the results of a targeted fact-finding as far as they relate to the topics covered by the CP.

ESMA is conscious of the fact that the matters covered in this consultation paper are also of interest to regulatory authorities outside the EEA. ESMA believes it is desirable to achieve a broad consistency of approach to these issues across different jurisdictions given the links between the financial markets of the EEA and the rest of the world. In the draft guidelines, ESMA has therefore sought to take account of developments in countries outside the EEA.

Next steps

In light of the comments received from respondents by the deadline of 3 October 2011, ESMA expects to publish final guidelines at the end of 2011.



Notes for editors

1. In April 2010, CESR (ESMA's predecessor) issued a call for evidence on micro-structural issues of the European equity markets (Ref: CESR/10-142).¹ This sought information on high frequency trading (HFT), sponsored access, co-location services, fee structures, tick size regimes and indications of interest.
2. In its Technical Advice to the European Commission in the Context of the MiFID Review – Equity Markets (Ref: CESR/10-802) of June 2010², CESR summarised the responses to the call for evidence and outlined an action plan on micro-structural issues.
3. ESMA continued its work on micro-structural issues in November 2010 and has since:
 - reviewed existing academic evidence on the effects of HFT;
 - considered relevant existing standards set by international regulatory bodies, national competent authorities (inside and outside the EEA) and industry bodies;
 - conducted a targeted fact-finding through questionnaires addressed to regulated markets, multi-lateral trading facilities and firms conducting high frequency trading, providing DMA and/or SA and/or using co-location/proximity hosting services;
 - addressed a questionnaire to buy-side firms on the impact of HFT on the quality of markets operated by trading platforms;
 - held a roundtable discussion with trading platforms, HFT firms and investment firms that responded to the fact-finding questionnaires;
 - consulted the Secondary Markets Standing Committee's Consultative Working Group on relevant policy questions related to all micro-structural issues; and
 - identified current gaps and possible legislative improvements in relation to micro-structural issues and highly automated trading in view of the upcoming MiFID and MAD review which would need legislative amendments to be adequately addressed.
4. This CP does not propose guidelines for co-location, fee structures and tick sizes. These topics do not relate directly to the challenges for systems and controls of trading platforms and investment firms caused by a highly automated trading environment. There is also a limit to what ESMA could achieve through guidelines in these areas under the existing legislative framework. ESMA has therefore decided at this stage to concentrate on issues related to organisational requirements in a highly automated trading environment, including DMA/SA services. However, this is without prejudice to ESMA's ability to undertake future work in these areas, particularly if and when changes to the legislative framework will have been made.
5. The draft guidelines sit under the existing legal framework provided by the Markets in Financial Instruments Directive (MiFID) and the Market Abuse Directive (MAD). These two directives are currently under review and the Commission has committed to making proposals to amend them in the course of 2011. However, ESMA considers that given the importance of the issues raised by automated

¹ http://www.esma.europa.eu/index.php?page=consultation_details&id=158

² http://www.esma.europa.eu/index.php?page=document_details&from_title=Documents&id=7003, pages 39-43



trading, including DMA/SA, regulatory developments outside the EU and the fact that competent authorities across the EEA are already seeking to deal with them within the existing legal framework, it is appropriate to introduce harmonised guidelines in the course of 2011. Once MiFID and MAD have been revised and the European Market Infrastructure Regulation (EMIR) is finalised, it will be necessary for ESMA to revisit the guidelines to consider whether they need to be adapted in the light of the new legislative framework or transformed into technical standards covering some or all of the issues in this paper.

6. ESMA is an independent EU Authority that was established on 1 January 2011 according to EU Regulation No. 1095/2010 as published on 15 December 2010 in the Official Journal of the European Union (L 331/84). The Authority contributes to safeguarding the stability of the European Union's financial system by ensuring the integrity, transparency, efficiency and orderly functioning of securities markets, as well as enhancing investor protection. In particular, ESMA fosters supervisory convergence both amongst securities regulators, and across financial sectors by working closely with the other European Supervisory Authorities competent in the field of banking (EBA), and insurance and occupational pensions (EIOPA).
7. ESMA's work on securities legislation contributes to the development of a single rule book in Europe. This serves two purposes; firstly, it ensures the consistent treatment of investors across the Union, enabling an adequate level of protection of investors through effective regulation and supervision. Secondly, it promotes equal conditions of competition for financial service providers, as well as ensuring the effectiveness and cost efficiency of supervision for supervised companies. As part of its role in standard setting and reducing the scope of regulatory arbitrage, ESMA strengthens international supervisory co-operation. Where requested in European law, ESMA undertakes the supervision of certain entities with pan-European reach.
8. ESMA also contributes to the financial stability of the European Union, in the short, medium and long-term, through its contribution to the work of the European Systemic Risk Board, which identifies potential risks to the financial system and provides advice to diminish possible threats to the financial stability of the Union. ESMA is also responsible for coordinating actions of securities supervisors or adopting emergency measures when a crisis situation arises.
9. ESMA replaced the Committee of European Securities Regulators (CESR), an advisory body comprised of EU securities regulators that advised the European Commission from 2001 to 2010 on policy issues around securities legislation.

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