

## **SECURITIES AND MARKETS STAKEHOLDER GROUP**

### **Responses to ESMA's Consultation paper on guidelines on systems and controls in a highly automated trading environment for trading platforms, investment firms and competent authorities**

#### **II. BACKGROUND**

**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?**

ESMA's Securities and Markets Stakeholder Group (hereafter "the Group") believes that the revision of the Markets in Financial Instruments Directive and of the Market Abuse Directive will have a significant impact on the regulation of the issues related to highly automated trading, in particular in respect to the systems and controls required from trading platforms and investment firms.

While the revision of these two directives is necessary to better regulate the above mentioned issues, the Group believes that by the meantime, ESMA's guidelines could have a valuable role in clarifying the requirements for trading platforms and investment firms under the current regulatory framework, and in ensuring that these requirements are applied consistently across all Member states and to all market participants, including trading platforms. However, it needs to be ensured that unsubstantiated regulation of HFT does not adversely affect the liquidity of trading venues and their innovation.

The Group therefore welcomes ESMA's initiative but believes that these guidelines will require adaption after the finalization of the MiFID and MAD. In the future, the regulation of the issues related to a highly automated trading environment, and, in particular, to high frequency trading (hereafter "HFT") should aim at applying the same rules to all trading platforms, including over-the-counter trading (hereafter "OTC"), so as to ensure a level playing field and avoid any distortions. In this respect, the Group believes that ESMA should play a role in this harmonisation enterprise, through, notably, the adoption of legally binding technical standards.

#### **III. 2. ORGANISATIONAL REQUIREMENTS FOR TRADING PLATFORMS AND INVESTMENT FIRMS IN A HIGHLY AUTOMATED TRADING ENVIRONMENT**

##### **a) TRADING PLATFORMS**

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



Yes, the Group believes that the suggested guidelines adequately capture all relevant points relating to the operation of trading platforms' electronic trading systems, except for the business continuity and resilience arrangements. Not only system failures should be addressed, but also incidents which could render unavailable staff, workspace or suppliers required to continue to operate the trading platform and related services.

In addition, the Group believes it important to apply the same guidelines to regulated markets and multi-lateral trading facilities (hereafter "MTFs") considering that HFT firms operate equally on these two types of trading platforms.

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

No, the Group believes that the organisational requirements are appropriate. Eventually, competition will ensure a high quality of the resilience of the trading systems.

Nonetheless, the Group believes that the guidelines on organisational requirements could include specific obligations on the prevention of conflicts of interests. In fact, there is a significant scope for conflicts of interests when the same firm combines activities such as the routing of client orders and of its own proprietary flow with the operation of and shareholding in a multilateral trading platform. The measures for the prevention of the conflicts of interests that may arise could take the form of greater disclosure obligations for firms combining the above mentioned activities (regular disclosures of the volumes of orders sent to the platforms the firms have a shareholding in, regular disclosures of the investigations carried out and the sanctions taken on the platform, ...). An alternative to these stricter disclosure requirements would be to place limits on the ownership of platforms by users.

Regarding records, it would be useful to have a harmonized minimum time for which it is mandatory to keep the records.

Also, regarding review, there are countries where an external review is mandatory. It would be useful to harmonize the type of review necessary (internal / external), in order to maintain the level playing field. Publicity of the audit opinion (or conclusion of evaluation) may be considered, in order to provide better protection for investors.

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

The Group has two additional comments:

A. Trading platforms should have appropriate capacity limits for volumes; however, the figures as suggested by ESMA are implausible (e.g. it is unrealistic to increase capacities to a multiple of up to 20 times the level of order flow of a peak day). Nowadays trading venues already monitor their system load very closely and calibrate their systems respectively in order to provide sufficient headroom at all times.

B. It is not clear why ESMA differentiates between members, participants and users which is confusing and misleading. The recommendation is to refer only to "members", because it does clarify that they have a legal relationship with the trading venue and therefore addresses the right entity in the context of this guideline.



## **b) INVESTMENT FIRMS**

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

Yes, the Group believes that the suggested guidelines adequately capture all the relevant points relating to the operation of trading algorithms, except for the business continuity and resilience arrangements. Similarly to trading platforms, not only system failures should be addressed, but also incidents which could render unavailable staff, workspace or suppliers required to continue to operate the trading.

In principle, it is important to stress that risk management at the source of the order flow is necessary and that therefore investment firms should have sophisticated risk management tools and safeguards in place.

### **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?**

No, the Group believes that the organisational requirements are appropriate.

### **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 to question 3 and to comment (2) in question 4.

## **III.3. DRAFT GUIDELINES ON ORGANISATIONAL REQUIREMENTS FOR TRADING PLATFORMS AND INVESTMENT FIRMS TO PROMOTE FAIR AND ORDERLY MARKETS IN A HIGHLY AUTOMATED TRADING ENVIRONMENT**

### **a) TRADING PLATFORMS**

### **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?**

Yes, the Group believes that all major aspects are covered. However, the Group believes that the suggestion to have “standards covering the knowledge of persons within members/participants and users that will be using order entry systems” would be best applied at the level of national regulators (through the adoption, for instance, of harmonised certification mechanisms) rather than at the level of the trading venues themselves, in order to ensure the consistency of these standards across the European Union.

In addition, the Group believes that identical circuit breaker and control rules should apply to all trading venues, in order to level the playing field and ensure an identical level of protection across all markets. On the contrary, if the rules were not the same, participants could continue trading on certain platforms without appropriate price-controls, as demonstrated by the “Flash Crash” example. These circuit-breaker and control rules should be adapted to the different financial products at stake.

### **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?**



No, the group believes that the organisational requirements are appropriate.

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

Yes, the Group has three additional comments:

A. There are two topics that are not correctly located at the chapter trading platforms. The part “standardised testing to ensure that the systems that members are using to access the venue have a minimum level of functionality that is compatible with fair and orderly trading on the venue” and “IT compatibility” should rather be included in the guidelines on organisational requirements for investment firms to promote fair and orderly trading. Investment firms are at the source of orders and ESMA correctly indicates that increased measures and controls are necessary.

B. Please refer to our comment (2) in question 4.

C. The Group strongly supports the concept of circuit breakers as they have a stabilising effect on the markets. However, further clarification and discussion on details which have not yet been discussed in this guideline is required (e.g. definition, scope and applicable instruments).

**b) INVESTMENT FIRMS**

**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?**

The Group believes it necessary to draw a list of the necessary controls on order entry for investment firms, so as to promote fair and orderly trading. However, the Group has the following three comments:

A. From an exchange perspective, it is necessary that parties responsible for operating algorithms must be accessible at all times. In addition, it is essential for surveillance functions to request all information concerning transactions and order entries (ask for beneficial ownership and/or trading intention) to constitute an initial suspicion. Due to the fact that the human trader has been (or is increasingly becoming) replaced by machines, it becomes harder for supervisors or trading venues and partly market participants to distinguish the final originator of the order. This should be part of the guidelines.

B. From a supervisory authority point of view it might be useful to receive the data necessary for investigation and back testing options. This would include the recording of all input and output parameters to be able to reconstruct the behaviour of the systems.

C. The Group recommends including the requirement that “Investment firms should ensure that the systems that they are using to access the venue have a minimum level of functionality that is compatible with fair and orderly trading on the venue”. This point was addressed in the guideline for trading venues to promote fair and orderly trading. However, as this is within the responsibility of the investment firm and not of the trading venue, it should rather be included for investment firms.



**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?**

No, the Group believes that the organisational requirements are appropriate.

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

No, the Group does not have additional comments.

### **III.4. DRAFT GUIDELINES ON ORGANISATIONAL REQUIREMENTS FOR TRADING PLATFORMS AND INVESTMENT FIRMS TO PREVENT MARKET MANIPULATION IN A HIGHLY AUTOMATED TRADING ENVIRONMENT**

#### **a) TRADING PLATFORMS**

**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?**

The Group believes that the organisational requirements are appropriate. However, it is crucial to ensure that all trading platforms bear the same organisational requirements to prevent market manipulation. The Group therefore recommends that in addition to the suggested guidelines, ESMA harmonise, as far as possible, the requirements both in terms of real-time and non-real time market surveillance for regulated markets and MTFs. Currently, only regulated markets are required to perform non-real time market surveillance, yet this function is crucial for the detection of market abuse, and should therefore be required from all trading platforms, be they regulated markets or MTFs.

More specifically, in respect of market abuse implemented through the use of HFT, the Group believes it important to differentiate between HFT (a technology) and the implementation of abusive strategies *per se*. HFT can facilitate the implementation of such strategies, but there is no intrinsic link between HFT and these strategies.

In addition, certain strategies facilitated by HFT can be considered as abusive in nature, while others should be judged on a case-by-case basis. In this respect, intention is an important element to take into account, and a clear line should be drawn between intentional and unintentional events. Along the same line, not only market abuse should be punished but also attempts at performing market abuse.

By way of example, the interaction of different algorithm models run by the same HFT player, can aim at implementing abusive strategies but not necessarily, and should therefore be assessed on a case-by-case basis. Similarly, ping orders and momentum ignition do not necessarily constitute market abuse, and should be assessed on a case-by-case basis, considering the intention, effects (notably in respect to the price of the instrument compared to its usual prices) and time span of the activity. On the contrary, the practice of quote stuffing is abusive by its very nature, since its aims at slowing down the trading processes of other participants.

It would be useful for the guidelines to include an Annex with a detailed consolidated list of practices which may constitute possible signals of market abuse, as already identified by the MAD.



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

The Group has two additional comments.

A. Please refer to our comment 2 in question 4.

B. The Group believes that, in addition to the monitoring of market abuse on individual trading venues, it is necessary to adopt mechanisms to monitor market abuse carried out on a cross-market basis. Such cross-platforms market abuse prevention and detection should be under the responsibility of competent authorities (level 1) and a centralised approach at the European level should ensure the coordination of these authorities (level 2). In this respect, ESMA could play an important coordination and monitoring role, with information flowing up from trading venues, to their competent authorities and then to ESMA and flowing down from ESMA to other competent authorities and to trading venues under their jurisdiction.

**b) INVESTMENT FIRMS**

**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?**

The Group believes that the guidelines on organisational requirements to deal with market manipulation for investment firms are sufficiently detailed.

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

Yes, the Group has three additional comments.

A. The Group suggests extending point 3 by adding “They should be able to provide supervisory authorities with necessary data for investigation and back testing options, when required. This would include the recording of all input and output parameters to be able to reconstruct the behaviour of the systems.” This will eventually help competent authorities.

B. Please refer to our response to questions 3.

C. Please refer to our response to question 7.

**IV. ORGANISATIONAL REQUIREMENTS FOR DIRECT MARKET ACCESS AND SPONSORED ACCESS**

**a) TRADING PLATFORMS**

**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?**



The Group believes that the suggested guidelines deal adequately with the differences between DMA and SA. However, the Group believes that the definition of DMA/ SA should include the aspect of due diligence (i.e. clients that should be subject to adequate due diligence) for both DMA / SA and the fact that the risk layer is part of the exchange venue and not at the member level for SA. In principle, it should be stressed that the responsibility of the service offered ultimately lies with the service provider.

In fact, the Group believes it important to differentiate between DMA and SA. Under DMA schemes, the operator of the trading platform establishes general rules and conditions but does not monitor the granting of DMA on a case-by-case basis. On the contrary, in respect to SA, the operator of a trading platform should have the ability to refuse the granting of SA by one of its users to a client, should be able to suspend or withdraw the SA and to stop the orders sent by a sponsored client separately from those of the sponsoring firm.

**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?**

No, the Group believes that the organisational requirements are appropriate.

**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?**

Yes, the Group has one additional comment on the point “require the member to conduct adequate pre-checks of their clients due diligence on any client to which it provides direct market access/ sponsored access”. It would be useful to add a short explanation of due diligence in the explanatory notes. It is important to have an adequate due diligence, however, it should be related to the business risk involved from the DMA/SA user.

#### **b) INVESTMENT FIRMS**

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

The Group believes that the suggested guidelines deal adequately with the difference between DMA and SA. However, the group believes that due-diligence issues should be dealt with within the guidelines, as explained in our response to question 18.

**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?**

No, the Group believes that all major aspects are covered.

**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?**



The Group believes that the guidelines are appropriate taking into account the comments in this response.

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

No, the Group does not have any additional comments.

**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?**

The Group believes that the explanatory text is useful. However, it should not be retained in the final set of guidelines, but rather be kept as an explanatory note.