MiFID II: Microstructural Issues

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High frequency (or '*algo*') trading was blamed for causing the '*flash crash*' in May 2010. Ever since, HFT has been the subject of much debate and regulators around the world have been investigating the impact of HFT on markets.

ESMA issued guidelines on automated trading (market participants were expected to comply by May 2012) (**"2012 ESMA Guidelines"**) in response. The stated aim of the 2012 ESMA Guidelines ensure "*common, uniform and consistent application of MiFID and MAD*". Notwithstanding, Germany separately passed the Act on the Prevention of Risks and Abuse in High frequency Trading in February 2013 and France adopted its own set of rules that applied from 1 January 2015.

Another limitation of the 2012 ESMA Guidelines was that they only directly applied to MiFD investment firms, regulated markets and MTFs and only applied indirectly to non-MiFID firms who have direct electronic access (**"DEA"**, direct market and sponsored access) due to the obligations imposed on MiFID firms and trading platforms. Hence the need to ensure further harmonisation to prevent regulatory arbitrage. MiFID II aims to achieve this by:

- widening the scope of MiFID to include prop-traders who are high frequency traders (**"HFTs"**), market makers and/or have DEA to a trading venue in the EU;
- raising the status of the 2012 ESMA Guidelines to legally binding rules; and
- introducing more details.

While regulators recognise that HFT provides liquidity in the market, the withdrawal of market making by such traders has potential to cause (or worsen) market disruptions, the effects of which, is more acute in stressed market conditions. MiFID II addresses this by requiring HFTs who act as market makers to provide liquidity on a regular and predictable basis by entering into market making agreements with trading venues.

A. HIGH-FREQUENCY TRADERS

1. How '*new*' are the new HFT requirements?

The level one directive requires firms and trading venues to establish effective systems and risk controls and ensure that trading systems are resilient and have sufficient capacity (Art. 17 and 48 of the MiFID II Directive). The recent ESMA draft RTSs flesh out those requirements.

As noted above, rules around algo trading and providers of DEA are not entirely new. The MiFID II organisational requirements build on, (and go beyond) the 2012 ESMA Guidelines. For example, MiFID II strengthens algo testing prior to deployment and firms will need to comply with more prescriptive requirements in relation to governance, business continuity, pre- and post-trade controls, real-time monitoring and security and access (which are specifically linked to cyber-security).

2. General organisational requirements

(a) Governance

Existing MiFID investment firms should be familiar with the governance requirements. RTS 6 imposes requirements in relation to clear lines of accountability; effective procedures and processes for escalating issues; and segregation of the risk control and compliance function from the trading function.

However, new requirements also apply. For example, senior management is required to designate a "*responsible party*" to sign off initial deployment or substantial update of an algo trading system or strategy or trading algo. Firms will need to consider who would be the most suitable (and willing) to take on this role. A responsible party is also required to review any material changes to the production environment related to algorithmic trading.

Outsourcing requirements will also be familiar to authorised firms. RTS 6 reminds firms that they cannot outsource their regulatory responsibility and specifically includes within the scope of the outsourcing requirements, software or hardware that is used in algo trading activities. ESMA decided not to adopt a materiality threshold on the basis that minor components of an IT system might have an important impact on the entire system.

The self-assessment requirements are more prescriptive than under the 2012 ESMA Guidelines. As part of this self-assessment, firms are required to stress test their systems, related procedures and controls to ensure that they are capable of withstanding increased order flows or market stresses. Such tests need to include at least running high messaging and trade volumes of at least twice the highest volume reached over the previous six months. The assessment needs to be performed annually and audited internally (where such function exists).

(b) Staff

The firm's risk management function and compliance function are expected to have the knowledge, skill and authority to follow up information provided by automatic alerts and challenge staff responsible for algo trading. Compliance will also be expected to either have access to the kill functionality at all times or have direct contact with a person who has access. HFTs will need to employ an adequate number of technical staff with necessary skills to manage, monitor and test their algorithmic trading systems and algorithms.

(c) Training

Additional training of staff may be required. The rules require that risk management and compliance staff need to be sufficiently knowledgeable about the firm's algo trading systems. Technical/IT staff need to understand regulatory obligations in relation to market abuse. RTS 6 clarifies that training to staff needs to be tailored to the role performed.

(d) Testing

MiFID II sets out testing requirements similar to those under the 2012 ESMA Guidelines. These require testing before initial deployment and after substantial changes to the algo.

The draft RTS (like the 2012 ESMA Guidelines) allow firms the option of using a non-live testing environment that is appropriate to the type of testing being performed, i.e., a firm's own testing environment, or a third-party test environment (provided by a trading venue, DEA providers, or vendor).

Firms will need to decide (if they have not already done so) whether to develop their own trading environment (which may involve incurring significant costs) or use a testing environment provided by a trading venue, DEA provider or a vendor. If the firm uses another's testing environment, this should be treated like a regulated outsourcing arrangement because the firm will retain full responsibility for testing. It should be noted that the testing requirements only apply to "*algorithms leading to order execution with limited or no human intervention*".

(e) Pre-trade controls

Although responses to ESMA's consultation highlighted that the proposed pre-trade controls were too detailed and they preferred the approach of the 2012 ESMA Guidelines, ESMA only streamlined this to four mandatory pre-trade controls. RTS 6 sets out four mandatory pre-trade controls applicable for trading in all instruments:

- price collars;
- max order value;
- max order volume; and
- max messages limit.

(f) Security and access

RTS 6 prescribes additional rules in relation to security and access. Firms will need to protect against both physical and electronic security breaches and will have to promptly inform their home state regulator of any material breaches.

Firms will also be required to undertake annual penetration tests and vulnerability scans to safeguard against cyber-attacks and restrict access systems and ensure traceability at all times.

(g) Notification and disclosure to regulators

Firms must notify their home state regulator and the home state regulator of the relevant trading venue that they are engaging in algo trading. A firm must also provide to home state regulator (on request and which may be passed onto the home state regulator of the trading venue) the following information:

- description of its algo trading strategies;
- details of the trading parameters or limits to which the system is subject; and
- the key compliance and risk controls that it has in place.

(h) Record-keeping

Records need to be kept in a prescribed format and include prescribed content. Firms should review the requirements to see what changes they need to make to their systems to allow for production of such records.

B. TRADING VENUES

Although article 48 of the MiFID II Directive only applies to regulated markets, ESMA has deliberately drafted RTS 7 so that it applies to "trading venues" (i.e. ESMA extended the requirements to MTFs and OTFs).

The requirements imposed on trading venues, broadly, mirror those imposed on investment firms (e.g. in relation to governance, staffing, outsourcing and testing before deployment), but there are also requirements specific to trading venues. For example, trading venues need to:

- establish effective systems, procedures and arrangements to reject orders that exceed pre-determined volume and price thresholds or which are clearly erroneous;
- have the ability to temporarily halt or constrain trading if there is a significant price movement in a financial instrument during a short period and, in exceptional cases, to be able to cancel, vary or correct any transaction;
- ensure it meets the greater monitoring obligations;
- have a business continuity plan;
- establish mechanisms to manage volatility; and

- ensure that its rules on co-location services and fee structures are transparent, fair and non-discriminatory.

C. PROVIDING DIRECT ELECTRONIC ACCESS

The general principle underlying the rules is that the investment firm is responsible for ensuring that its DEA clients comply with MiFID II and trading venue rules. The DEA rules require the firm to:

- enter into a binding agreement regarding the DEA service provided;
- notify its (and the trading venue's) homes state regulator(s) that they are providing DEA;
- monitor client orders;
- ensure that all client orders pass through their pre- and post- trade;
- be able to block or cancel client orders; and
- identify and report suspicious transactions.

Therefore, firms who provide DEA may want to review their DEA client agreements to see if they are able to achieve the above, e.g. do they have sufficient monitoring rights and the ability to stop client orders from being executed.

D. MARKET MAKING STRATEGIES

Firms engaging in algo trading pursuing a market making strategy will be required to carry on the market making continuously during a specified proportion of the trading venue's trading hours (except in exceptional circumstances). Trading venues will also be required provide incentives under market making schemes, particularly during stressed market conditions.

1. What constitutes an exceptional circumstance?

Trading venues are required to announce the existence of an exceptional circumstance and therefore unless and until the trading venue has identified such a circumstance, the firm must continue to provide liquidity, save for where the firm is unable to maintain prudent risk management practices by virtue of technological or risk management issues. Draft RTS 8 sets out the situations constituting exceptional circumstances. These include:

- situations of extreme volatility;
- act of war, industrial action, civil unrest or an act of cyber sabotage;
- situations where the fair, orderly and transparent execution of trades is compromised by, for instance, multiple errors; and
- for non-equity instruments, where a national competent authority has temporarily suspended the pre-trade transparency requirements following a significant decline in liquidity of a particular class of financial instruments.

However, "*regular or pre-planned information events*" will not be considered exceptional circumstances. There is no guidance on what pre-planned information event includes.

2. Obligation to enter into market making agreements

As per draft RTS 8, where a firm is pursuing a market making strategy for at least 50% of the daily trading hours of continuous trading at the trading venue, excluding opening and closing auctions, for half of the trading days over a one month period, it will be obliged to enter into a market making agreement with the trading venue.

Draft RTS 8 also prescribes the content of such agreements. For instance, it must include at least the financial instrument(s) covered; the minimum obligations to be met in terms of presence, size and spread, the terms of the market making scheme (if appropriate); and obligations in relation to resumption of trading after volatility interruptions; and monitoring by the firm and trading venue (for compliance with the agreements and the trading venue's market making schemes).

The minimum obligations to be met requires the firm to post quotes for no less than 50% of the hours during which continuous trading takes place during daily trading hours excluding opening and closing auctions, and calculated for each trading day.

3. Market making schemes

Trading venues only need to have market making schemes in place for certain classes of financial instruments - liquid shares and liquid ETFs and options and futures directly related to those instruments, liquid equity index futures, and liquid equity index options.

Trading venues must describe in their scheme the incentives and parameters (presence, size and spread) to access those incentives under both normal trading conditions and stressed trading conditions (which needs to take into account of inherent additional risks).

Under normal trading conditions, trading venues are not required to offer incentives. Trading venues are required, however, to provide the same incentives to the participants who perform the same in terms of presence, size and spread.

Trading venues are not allowed to limit the number of participants in a market making scheme, but is allowed to limit access to the incentives included to firms that have met pre-determined thresholds.

Increased transparency to ensure fair and non-discriminatory market making schemes has also been introduced. Trading venues must publish the terms of their market making schemes on their website, along with the names of the firms that have signed market making agreements under each of those schemes and the financial instruments covered by those agreements. Changes to the terms of a market making scheme needs to be communicated one month prior to their application.

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