Simmons & Simmons

Legal Framework Conditions for the High Frequency Trading Act ("HFT-Act")

Jochen Kindermann,
Partner,
Financial Services

BAI Insight 14
High Frequency Trading – Myth and Reality

29 January 2013

Simmons & Simmons

Agenda

- **Background**
  State of Proceedings
- **German HFT Proposal**
  Addressees and Methods
  - **High Frequency Trading**
    Definition and Requirements
  - **Algorithmic Trading**
    Definition and Requirements
  - **Trading Venues**
    Obligations and Sanctions
- **High Frequency Trading**
  EU (MiFID 2) and Advanced Initiatives
- **Forecast**
  Changes and Effects

© Simmons & Simmons 2009

Background – High Frequency Trading market share

- 70% of all exchange transactions in United States
- 40% of all exchange transactions in Germany
- 60% of all exchange transactions in United Kingdom
- “Negligible” amount of trading on HKEX's markets



© Simmons & Simmons 2009

Simmons & Simmons

Background – Challenges and Goals

- Challenges / Risks of HFT
  - Market manipulation
  - Cascading effects
  - Overloading of the trade systems
- Goals of the HFT-Regulation
  - Increasing the stability and integrity of the German financial markets
  - Minimizing market risks
  - Preventing market manipulation
  - Closing Regulatory gap
  - Protection of long-term investors



© Simmons & Simmons 2009

Simmons & Simmons

Background – Timing

Discharging and taking effect	Q1/13
Committee hearing	01/13
Briefing by Federal Government	12/12
1. Consulting Bundestag, Transfer to Committee	11/12
2. Draft Federal Government	11/12
1. First reading Federal Council, Statement	11/12
Plenary Application of Hesse	11/12
Draft Federal Government	09/12
Draft Federal Ministry of Finance	07/12
Application of governmental parties	03/12
Schäuble proposal	03/12

© Simmons & Simmons 2009

Simmons & Simmons

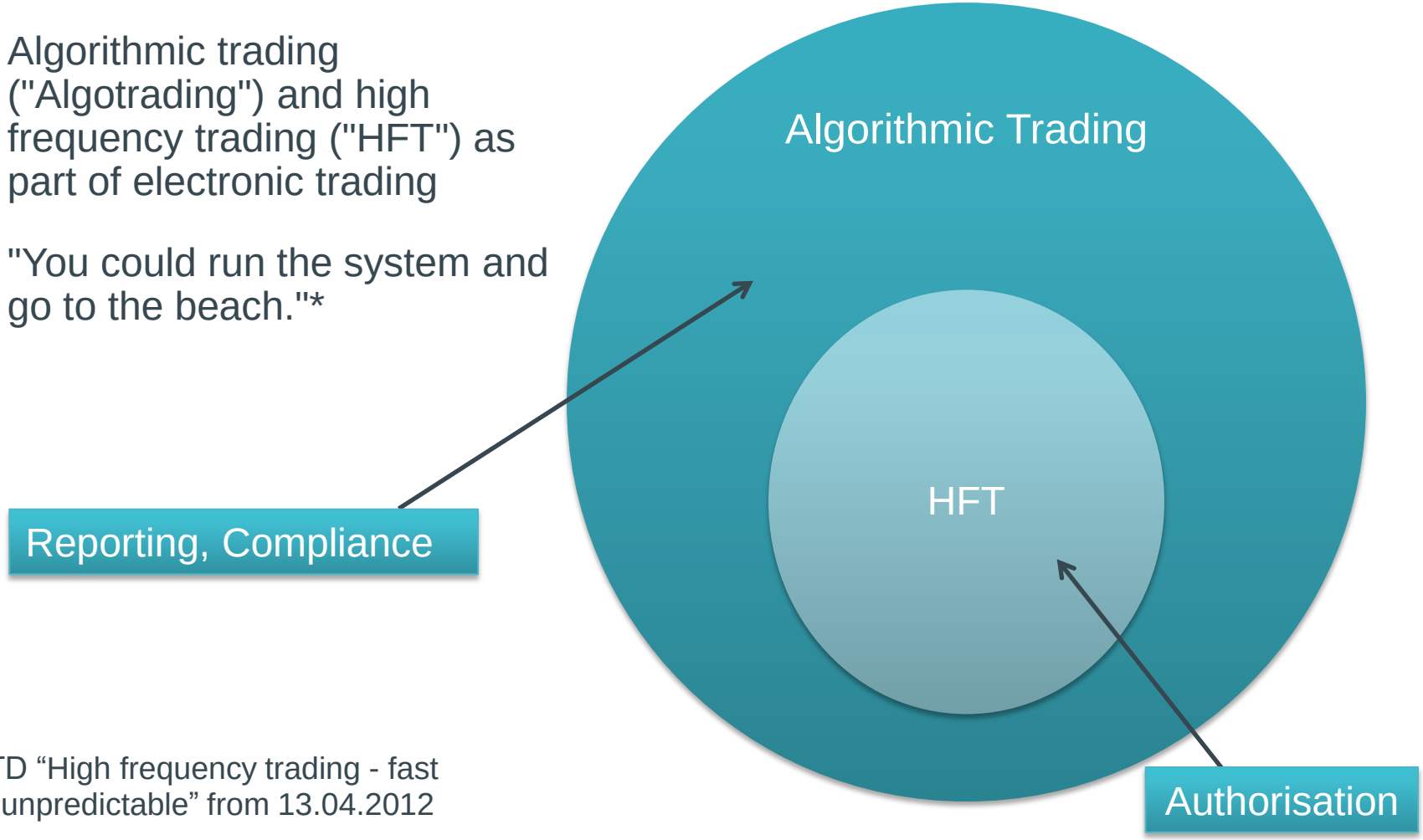
Agenda

- **Background**
  State of Proceedings
- **German HFT Proposal**
  Addressees and Methods
  - **High Frequency Trading**
    Definition and Requirements
  - **Algorithmic Trading**
    Definition and Requirements
  - **Trading Venues**
    Obligations and Sanctions
- **High Frequency Trading**
  EU (MiFID 2) and Advanced Initiatives
- **Forecast**
  Changes and Effects

© Simmons & Simmons 2009

Addressees – Defining Algotrading and HFT

- Algorithmic trading ("Algotrading") and high frequency trading ("HFT") as part of electronic trading
- "You could run the system and go to the beach."*



* FTD “High frequency trading - fast and unpredictable” from 13.04.2012

© Simmons & Simmons 2009

Addressees – HFT and Algotrading

High Frequency Trading

"Buying or selling of financial instruments for its own account as a direct or indirect participant [...] through the use of computers

- in fractions of a second
- detect changes in market prices,
- rules trading decisions according to independently meet and independently
- determine its order parameters according to these rules, adapt and transmit even without service to others"

Sec. 1 para. 1a No. 4d Banking Act draft

Algorithmic Trading

"Operation of the trade with financial instruments in such a way that“

- a computer algorithm
- the individual parameters of the order automatically determines

without that it is a system that only to the transfer of jobs to one or more exchanges or to confirm orders used (algorithmic trading).
Order parameters are within the meaning of sentence 1, in particular, decisions, whether the job should be initiated, over the time, price or quantity of the order or the order will be processed after its filing with limited or even no human participation“

Sec. 33 para. 1a Securities Trading Act draft

Simmons & Simmons

Agenda

- Background
  State of Proceedings
- German HFT Proposal
  Addressees and Methods
  - High Frequency Trading
    Definition and Requirements
  - Algorithmic Trading
    Definition and Requirements
  - Trading Venues
    Obligations and Sanctions
- High Frequency Trading
  EU (MiFID 2) and Advanced Initiatives
- Forecast
  Changes and Effects

© Simmons & Simmons 2009

High Frequency Trading – Defining proprietary trading after sec. 1 para. 1a No. 4 Banking Act

Proprietary Trading

"The continuous offer of purchase or sale of financial instruments on a regulated market or in a multilateral trading system to own prices, frequent organized and systematic operating from trading for its own account outside an organised market or a multilateral trading system, by providing a system accessible to third parties, to conduct operations with them, or the purchase or sale of financial instruments **for its own account as a service for other (proprietary trading)**"

© Simmons & Simmons 2009

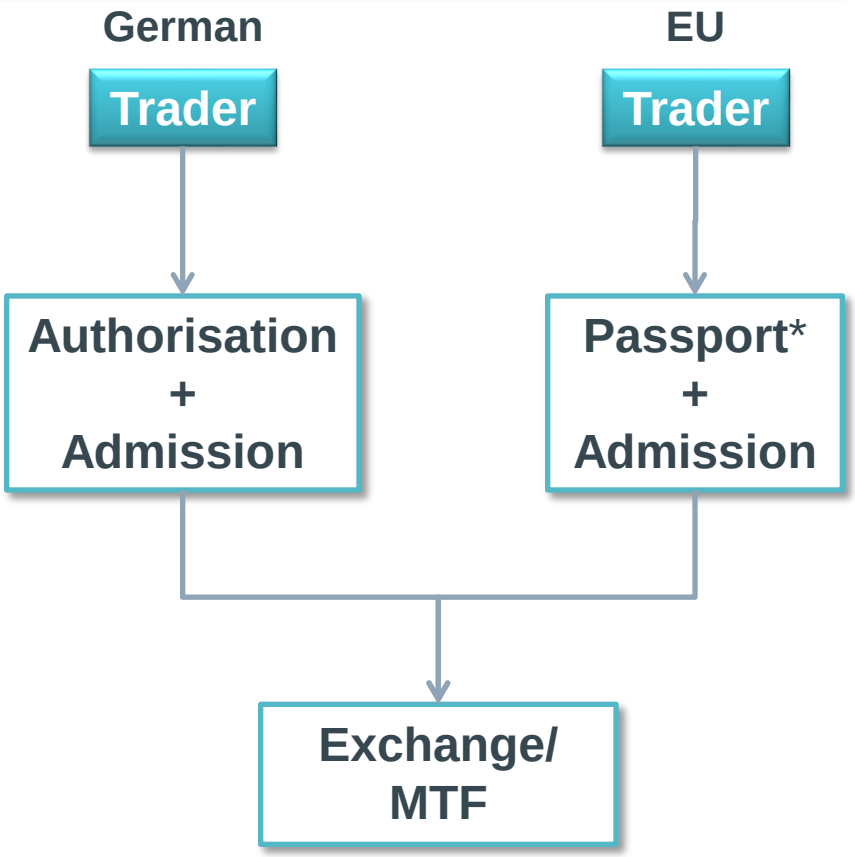
High Frequency Trading – Authorisation Requirement

Requirements for direct participants (G/EU)

Today

- Strict conditions for admission according to sec. 19 Exchange Act in conjunction with sec. 26 et seq. Exchange Rules for Eurex
  - Proper business transactions must be ensured
  - Proper technical connection to the trading system must exist
  - EUR 50,000 equity, authorisation or passport pursuant to sec. 53b Banking Act

New



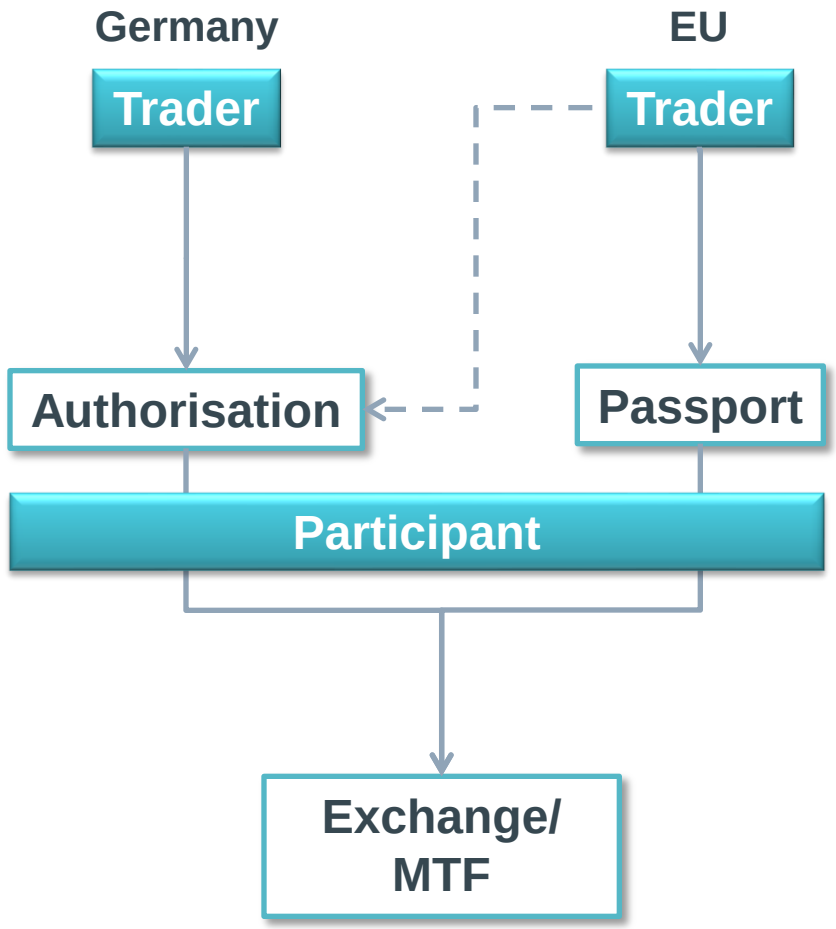
*Sec. 53b Banking Act

© Simmons & Simmons 2009

High Frequency Trading – Authorisation Requirement

Requirements for indirect participants (G/EU)

	Traders with authorisation after sec. 32 Banking Act	Traders not yet authorised
German Traders	⛔	➕
EU-Traders with Passport	⛔	➕

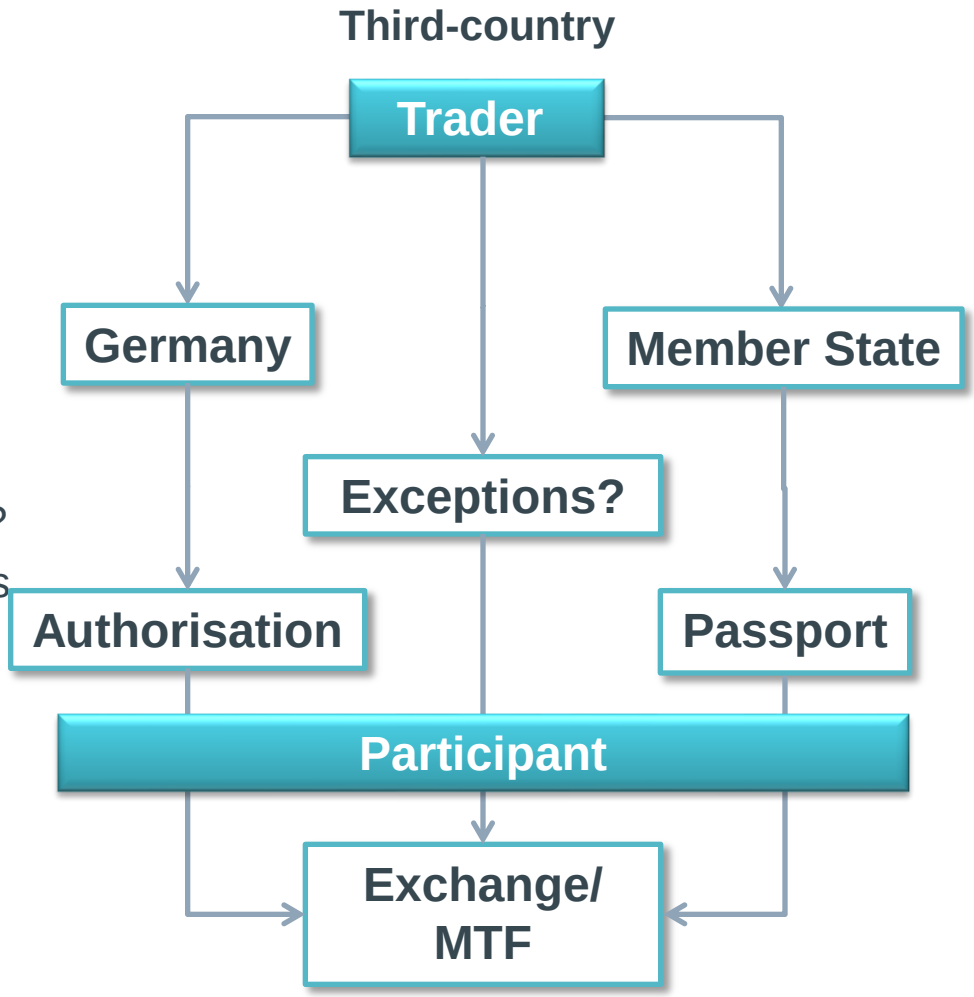


© Simmons & Simmons 2009

High Frequency Trading – Authorisation Requirement

Requirements for indirect participants (Third-country)

- Even indirect participants from third countries are in the scope
- Requirements
  - Authorisation according to sec. 32 Banking Act
  - Permission in one Member State + Passport
  - Exceptions to sec. 53c Banking Act?
    - Possible only for a few countries
    - Formalistic and time consuming



© Simmons & Simmons 2009

High Frequency Trading – Authorisation Requirements

- Financial services after sec. 1a Banking Act operated in accordance with sec. 32 Banking Act only with the written permission of the German Federal Financial Supervisory Authority (BaFin)
  - Offense and not a mere misdemeanor
- Physical presence in Germany
- Capital requirements
  - EUR 730,000 Equity
- On-going reporting requirements
- Transition period fixed in sec. 64p Banking Act draft
  - Temporary authorisation for recently acquired companies
  - Authorisation requests must be made within one month after the High Frequency Trading Act enters into force,
  - No new application must be made with existing authorisations

© Simmons & Simmons 2009

Simmons & Simmons

High Frequency Trading – Critical Points

- Federal Council of Germany („Bundesrat“)
  - Stimulates minimum holding period
  - Authorisation requirement should be eliminated and replaced with more stringent reporting
- Financial Industry
  - Authorisation in accordance with the Banking Act does not improve the quality of supervision
  - Annual fees of EUR 50,000 to 150,000 for market participants who previously needed no Banking Act authorisation
  - Competitive disadvantages for German financial market
  - Distorted distinction between HFT and Algotrading



© Simmons & Simmons 2009

Simmons & Simmons

Agenda

- Background
  State of Proceedings
- German HFT Proposal
  Addressees and Methods
  - High Frequency Trading
    Definition and Requirements
  - Algorithmic Trading
    Definition and Requirements
  - Trading Venues
    Obligations and Sanctions
- High Frequency Trading
  EU (MiFID 2) and Advanced Initiatives
- Forecast
  Changes and Effects

© Simmons & Simmons 2009

Algorithmic Trading – Definition according to sec. 33 para. 1a Securities Trading Act draft

Algorithmic Trading

"Operate trading with financial instruments in such a way that a **computer algorithm automatically determines** the individual parameters of the order unless it is a system that is used only **to route jobs** to one or more exchanges or the **confirmation of orders** (algorithmic trading).
Order parameters are within the meaning of sentence 1, in particular decisions, whether the job **should** be initiated, over **time, price** or **quantity** of the order or the order will be processed after its filing with limited or even no human participation"

© Simmons & Simmons 2009

Algorithmic Trading – Organisational Obligations

- "Resilient" trading systems with "reasonable" trading levels and thresholds
- Avoidance of
  - Submission of incorrect orders
  - Functions that can cause market disruptions
- Trading systems can not be used for any purpose, against
  - Market abuse rules or
  - Violates rules of trading
- "Effective" emergency arrangements
- Documentation of any change of used computer algorithms



© Simmons & Simmons 2009

Algorithmic Trading – Transparency and Compliance

- "Algo-Identifier": electronic identification of any algorithmically-generated orders - "Flagging" pursuant to sec. 16 para. 2 Exchange Act draft
- Testing and monitoring of own systems
- Special Right of Supervisors in accordance with sec. 3 para. 4 Exchange Act draft and sec. 4 para. 3a Securities Trading Act draft
  - BaFin, securities and Exchange Commission, trading surveillance units
  - At any time entitled to information about algorithmic trading and systems
  - Description of algorithmic trading strategies and their parameters
- Authority to ban certain algorithmic trading strategies

© Simmons & Simmons 2009

Algorithmic Trading – Market Manipulation

- Potentially market manipulative trading practices by ESMA
  - Ping Orders
  - Quote-Stuffing
  - Momentum Ignition
  - Layering und Spoofing: Report of BaFin from 18 December 2012
- Market manipulation according to Market Manipulation Definition Ordinance draft includes trading,
  - to disturb or delay the functioning of the trading system,
  - the detection of purchasing or selling orders in the trading system makes it difficult for third parties,
  - creating a false or misleading impression with regard to the supply or demand for a financial instrument.

© Simmons & Simmons 2009

Simmons & Simmons

Algorithmic Trading – Critical Points

- Federal Assembly
  - Recommends postponement of national rules to MiFID 2
  - Instead, additional compliance requirements
- Industry
  - Hasty action of the German legislature
  - No clear definition of the types of trading
- EZB: implement „Trader-ID“



© Simmons & Simmons 2009

Simmons & Simmons

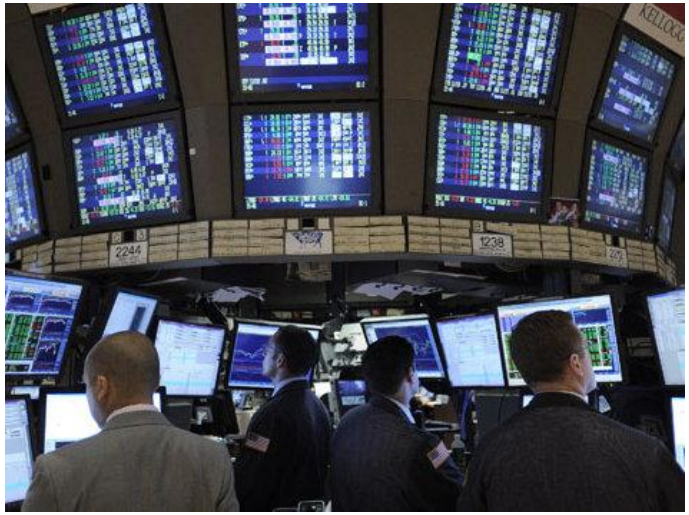
Agenda

- **Background**
  State of Proceedings
- **German HFT Proposal**
  Addressees and Methods
- **High Frequency Trading**
  Definition and Requirements
- **Algorithmic Trading**
  Definition and Requirements
- **Trading Venues**
  Obligations and Sanctions
- **High Frequency Trading**
  EU (MiFID 2) and Advanced Initiatives
- **Forecast**
  Changes and Effects

© Simmons & Simmons 2009

Trading Venues – Additional requirements for trading venues

- Obligation to take "appropriate" measures, including proper identification of high volatility of the share price guarantee (Sec. 24 para. 2a Exchange Act as amended)
  - Short-term changes of the market model and short-term volatility breaks
  - Limit systems
- Separate charges / fees for "excessive" use according to sec. 17 para. 4 Exchange Act
  - "Effective" level of fees/charges
  - Special status: Participants to determine the prices



© Simmons & Simmons 2009

Trading Venues – Order-Transactions-Ratio

- Ensure a "reasonable" relationship within the meaning of sec. 26a Exchange Act draft
  - For a financial instrument
  - Volume within one month
- "Economically" comprehensible
  - Liquidity of the financial instrument
  - Specific market or
  - Function of the acting company
- Ratio must be determined
  - By Exchange Rules (Exchange / MTF) or ordinance (MTF)
- Determining a "reasonable" size minimum price change (Sec. 26b Exchange Act as amended)

© Simmons & Simmons 2009

Trading Venues – Sanctions

- Sanctions according to sec. 19 para. 8 Exchange Act
  - Order-Transactions-Ratio not observed
  - Suspension of license for a maximum period of six months
  - Revocation for repeated violations



© Simmons & Simmons 2009

Simmons & Simmons

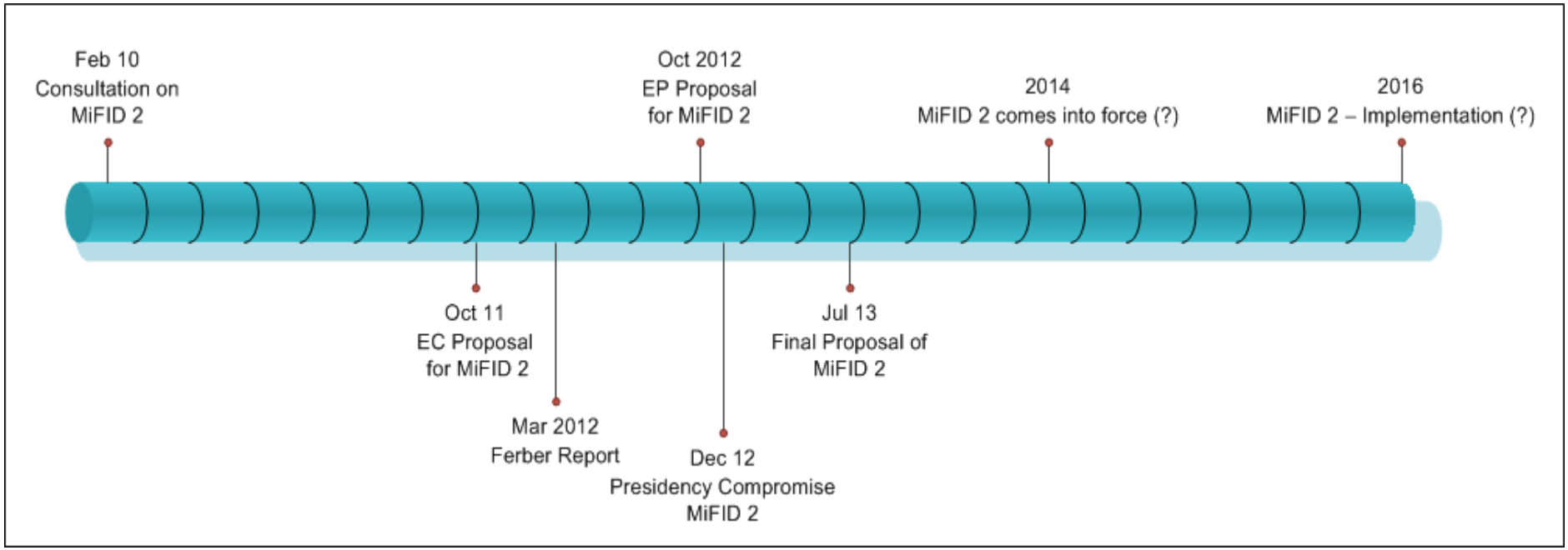
Agenda

- **Background**
  State of Proceedings
- **German HFT Proposal**
  Addressees and Methods
  - **High Frequency Trading**
    Definition and Requirements
  - **Algorithmic Trading**
    Definition and Requirements
  - **Trading Venues**
    Obligations and Sanctions
- **High Frequency Trading**
  EU (MiFID 2) and Advanced Initiatives
- **Forecast**
  Changes and Effects

© Simmons & Simmons 2009

Simmons & Simmons

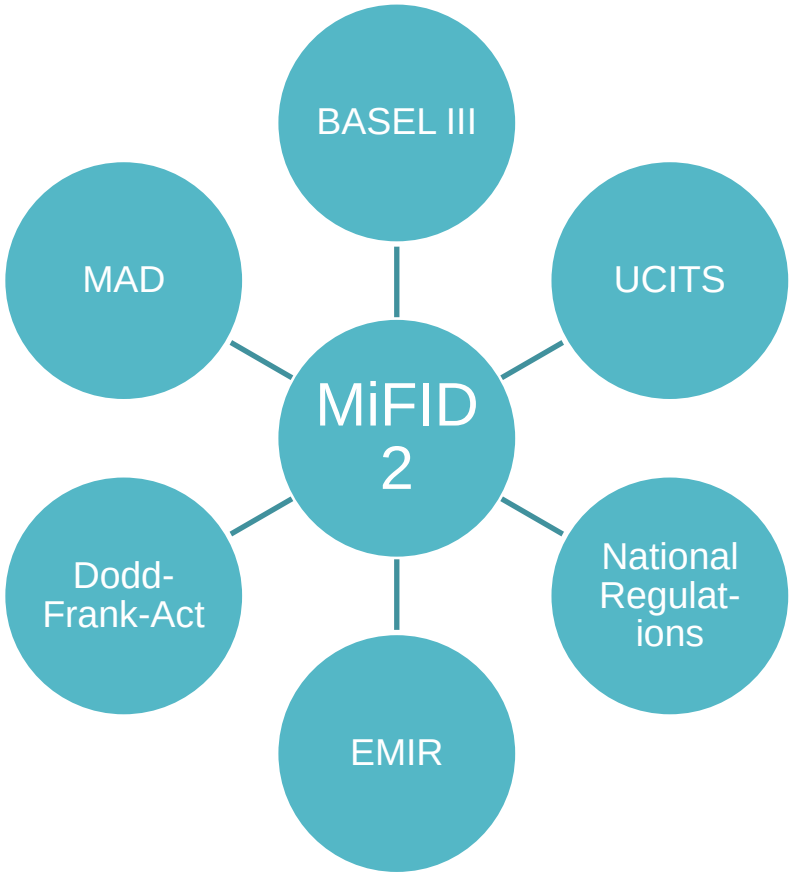
Comparison – Schedule of MiFID 2



© Simmons & Simmons 2009

Comparison – Current State

- Partially deviating designs by Parliament and the Commission
- Regulations in other countries
  - F: Transaction Tax
  - HK: Algotrading regulated
  - GB/USA: No regulations
- Continue to be influence by BASEL III, UCITS and the market



© Simmons & Simmons 2009

Comparison – Definition High Frequency Trading

High Frequency Trading Act

"The use of computers, which detect split-second changes in market prices, make trading decisions independently according to predefined rules and determining the corresponding order parameter according to the rules themselves, adapt and transmit, without service for others“

MiFID 2 Art. 4 No. 30a

“‘High frequency algorithmic trading technique’ means any algorithmic trading technique characterised by:
(a) infrastructure intended to minimise network and other types of latencies, including at least one of the following facilities for algorithmic order entry: co- location, proximity hosting, or high speed direct electronic access;
(b) system determination of order initiation, generating, routing or execution without human intervention for individual trades or orders; and
(c) high message intraday rates which constitute orders, quotes or cancellations.”

Latest Presidency Compromise

© Simmons & Simmons 2009

Comparison – Definition Algorithmic Trading

High Frequency Trading Act

"Operate trading with financial instruments in such a way that a computer algorithm automatically determines the individual parameters of the order unless it is a system that is used only to route jobs to one or more exchanges or the confirmation of orders (algorithmic trading).
Order parameters are within the meaning of sentence 1, in particular decisions, whether the job should be initiated, over time, pricing or quantity of the order or the order will be processed after its filing with limited or even no human participation"

MiFID 2 Art. 4 No. 30

"'Algorithmic trading' means trading in financial instruments where a computer algorithm automatically determines individual parameters of orders such as whether to initiate the order, the timing, price or quantity of the order or how to manage the order after its submission, with limited or no human intervention. This definition does not include any system that is only used for the purpose of routing orders to one or more trading venues or for the confirmation of orders."

Latest Presidency Compromise

© Simmons & Simmons 2009

Comparison – European Regulations

- MiFID 2 to High Frequency Trading
  - Commission´s draft: Broad agreement with the German Government's draft
  - Parliament´s draft: Proposed amendments with significantly stricter regulation
    - Minimum holding period of 500 milliseconds
    - Definition of High Frequency Trading Strategies
    - Continuous adaptation to technical innovations
- MiFID 2 to Algotrading
  - Commission´s draft: Broad agreement with the High Frequency Trading Act
  - Parliament´s draft: Includes much stricter regulation

© Simmons & Simmons 2009

Simmons & Simmons

Agenda

- **Background**
  State of Proceedings
- **German HFT Proposal**
  Addressees and Methods
  - **High Frequency Trading**
    Definition and Requirements
  - **Algorithmic Trading**
    Definition and Requirements
  - **Trading Venues**
    Obligations and Sanctions
- **High Frequency Trading**
  EU (MiFID 2) and Advanced Initiatives
- **Forecast**
  Changes and Effects

© Simmons & Simmons 2009

Forecast – Changes and Effects

- Consultation of the Economic and Financial Committee on 16 January 2013
  - Changing the definition
  - Examination of minimum holding periods or retention
- MiFID 2
  - Replace national regulations
  - Orientation toward German laws (?)



© Simmons & Simmons 2009

Simmons & Simmons



Jochen Kindermann
Partner, Financial Services
+49 (0)69 907 454 43
jochen.kindermann@simmons-simmons.com

simmons-simmons.com
elexica.com

© Simmons & Simmons 2009