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Update: German Government Adopts Draft Legislation to Regulate High Frequency Traders and Algorithmic Trading Strategies on German Trading Venues

The German Government plans to curtail high frequency trading on German trading venues and to submit certain algorithmic trading strategies to regulatory supervision. In its cabinet meeting on September 26, 2012 the Federal Government adopted a revised draft legislation titled the "Act for the Prevention of Risks and the Abuse of High Frequency Trading" (*Hochfrequenzhandelsgesetz*).[1] This note provides a short overview on the adopted draft legislation and explains the main differences to the earlier discussion draft described in our client publication in August 2012.[2]

Overview

Today, algorithmic high frequency trading accounts for approximately 50% of the trading volume at German trading venues. Currently, Germany has no specific rules applying to high frequency and other algorithmic traders and trading strategies. Since extreme and irrational price fluctuations like the US flash crash on May 6, 2010 have occurred, there is an increasing concern about the impact of computer based algorithmic high frequency trading ("HFT") and its impact on market integrity and efficiency. These worries appear to be supported by subsequent events like the Knight Capital trading glitch and various other events blamed on HFT.

Although European trading venues have not suffered from similar market glitches involving HFT, on a European level, these concerns will be addressed by the proposed reform of the Markets in Financial Instruments Directive ("MiFID II"), which will introduce, among others, a specific supervisory framework for algorithmic trading activities.[3] The German Government wants Germany to be a frontrunner in the regulation and supervision of algorithmic traders and trading and does not want to wait until MiFID II has been adopted.

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[1] The draft is available at http://www.bundesfinanzministerium.de/Content/DE/Downloads/Abt_7/2012-09-26-PM56-Hochfrequenzhandel.pdf.

[2] Available at http://www.shearman.com/speed_limit_for_high_frequency_traders-02-08-2012/.

[3] *Cf*. Art. 17 MiFID II.

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On July 30, 2012, the German Ministry of Finance presented a new draft legislation in the form of an "Act for the Prevention of Risks and the Abuse of High Frequency Trading" (*Diskussions-Entwurf eines Hochfrequenzhandelsgesetzes*). The new draft legislation targets the specific risks in connection with computer based high frequency trading at German trading venues, but will also affect other traders at German trading venues using algorithmic trading strategies.

The German draft legislation plans to introduce, among others, the following: [4]

- A license requirement for HFT firms;

- Supervision of HFT firms as financial services institutions under the German Banking Act (*Kreditwesengesetz*);

- Specific organizational requirements for firms engaged in algorithmic trading;

- An adequate ratio between sale and purchase orders and executed transactions; and

- Increased enforcement powers of stock exchange supervisory authorities and BaFin vis-à-vis firms engaged in algorithmic trading, including a right to request further information on the algorithms and the trading strategies.

On September 26, 2012 the German Government adopted the original discussion draft in a slightly amended form. Compared to the earlier discussion draft, the adopted draft:

- further expands the license requirement for firms using algorithms for trading at German trading venues; and

- introduces a new obligation to "earmark" every order generated by algorithms.

The adopted German draft legislation is not as extensive as certain elements in the European Commission's MiFID II proposal and that are part of the ongoing discussion on the regulation of algorithmic traders on a European level. In particular, Germany has refrained from introducing a market making obligation for HFT firms as proposed by the European Commission as part of MiFID II.[5] The German Government also resisted requests to introduce a minimum resting time. However, at the European level, on September 26, 2012, the European Parliament's Economic and Monetary Affairs Committee agreed upon enhancing the MiFID II proposal with a minimum 500 millisecond resting period for each order, during which it will not be possible to cancel or modify the order.

Germany will be much faster in rolling out the new legislation: While MiFID II needs to be adopted at the EU level before being transposed into national law, the German draft legislation will become effective as soon as the German Parliament adopts the draft legislation and it is published in the Federal Gazette. Both can be expected to happen within the next few months.

Expanded License Requirement

Under the current regulatory framework applicable in Germany, HFT firms that exclusively trade in financial instruments for their own account and do not otherwise provide banking or financial services do not require a license under the German Banking Act, unless they qualify as market makers.

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[4] A detailed discussion can be found in our Client Publication from August 2, 2012 available at
http://www.shearman.com/speed_limit_for_high_frequency_traders-02-08-2012/.
[5] Art. 17(3) of the MiFID II proposal.

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The discussion draft published on July 30, 2012 broadened the definition of proprietary trading (*Eigenhandel*) and provided that entities engaged in the "purchase or sale of financial instruments using HFT strategies by an entity for its own account as a member of a German regulated market or multilateral trading system, even when not offered as a service for others", qualifies as proprietary trading (*Eigenhandel*) and would be subject to a license requirement as financial services institutions (*Finanzdienstleistungsinstitut*) under the German Banking Act.

The revised draft adopted by the German Government further specifies and broadens the definition of proprietary trading (*Eigenhandel*). Any institution that engages in the "purchase or sale of financial instruments for its own account as a <u>direct or indirect member of a German regulated market</u> or multilateral trading facility <u>by using computers, which are able to recognize changes in the market price in a split second, make autonomous market decisions following predefined rules and choose and transfer the adequate order-parameters</u>, even when not offered as a service for others" will now be subject to a license requirement. The adopted draft clarifies that also <u>indirect members</u> of a German trading venue are covered by the license requirement. The reasons to the adopted draft specify that "indirect members" are all trading firms that via an agreement with a venue's member are allowed to use the member's trading-ID to direct orders to a venue. Thus, the expanded definition should cover all forms of access to trading venues through a direct exchange member including "sponsored access" and "direct market access". This had been unclear under the initial version of the draft.

In addition, the revised definition does not only cover dedicated HFT firms, but <u>many other institutions using algorithmic systems to execute orders</u>, provided that the algorithms they use are able to identify market fluctuations in a fraction of a second and are programmed in a way that they automatically and independently form a trading decision and choose and submit the order-parameters to the trading venue. This will mean that, for example, many investment banks, hedge funds and other investment funds and/or their managers trading at Deutsche Börse or the Eurex exchanges could be subject to a license requirement under the German Banking Act, even if they do not have a physical presence in Germany or have co-located their servers with Deutsche Börse or Eurex in Frankfurt/Eschborn.

However, the new license requirement does not mean that a firm falling under the definition above necessarily needs to apply for a separate license in Germany. Firms licensed for proprietary trading in another member state of the EU/EEA area can profit from the European Passport rules and passport their activities into Germany provided their licensed activities fall under MiFID or the Banking Consolidation Directive. This is clarified in the official reasons to the adopted draft. Only firms <u>not</u> licensed in Germany or another EU/EEA member state for proprietary trading have no other option than applying for a (German) license with BaFin as financial services institution, or to curtail their activities to avoid triggering a license requirement in Germany, or alternatively to completely withdraw from German trading venues.

For institutions requiring a license there will be a transitional period of only three months after the new act's promulgation during which the license application must be submitted to BaFin.

Additional Transparency Requirements

In addition to the specific organizational and disclosure requirements for firms engaged in algorithmic trading that are discussed in our Client Publication dated August 2012, the adopted draft legislation introduces another element that is targeted to increase transparency.

Currently, it is very difficult if not impossible for supervisory authorities to identify whether an order has been generated electronically by an algorithm or not. In addition, supervisory authorities face enormous challenges to reconcile a specific order or series of orders with a specific algorithm if the trading firm uses many different algorithms at the same time. This is also one of the major reasons why it is currently very difficult to identify and prove abusive trading strategies. It is also impossible for supervisory authorities to monitor the prohibition of certain trading strategies without a clear identification of the trading strategy that is applied and the algorithm used to generate the order.

The revised draft addresses this problem by additional transparency requirements: every order for which an algorithm has automatically determined the trading parameters must be "earmarked" as such. In addition, the order must identify the algorithm that has been used to generate the order. This does not mean that the whole algorithm must be disclosed. It is necessary and sufficient that the specific algorithm that has been used can be identified via an electronic code.

The result will be additional transparency at the trading venue as to the use of algorithms. It enables the trading venue and the supervisory authority to reconcile every trade with the underlying algorithm and trading strategy.

It is worth noting that this requirement does not only cover HFT firms, but <u>all investment firms engaged in algorithmic trading at German trading venues</u>.

Outlook

Prior to addressing MiFID II, firms engaged in algorithmic trading will have to deal with the German draft legislation. As set out above, certain elements of the new legislation will not only cover dedicated HFT firms, but also many other firms, such as certain hedge funds and other institutional investors using algorithms for trading at German trading venues, irrespective of whether they are a member at the relevant trading venue or have only indirect access via another firm's membership.

Financial institutions engaged at German trading venues should have a close look at the draft legislation and analyze its impact. If a German license requirement is triggered, "European Passport" rules may avoid additional licensing in Germany. In addition, each firm engaged at German trading venues needs to review its organizational and strategic processes and adjust them, if necessary, to the new organizational and transparency requirements introduced by the new legislation.

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This publication is intended only as general information on these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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