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"Speed Limit" for High Frequency Traders – German Government Publishes Draft Legislation to Regulate Algorithmic Traders and Trading Strategies on German Trading Venues

For many foreigners, Germany is famous for its "autobahns", where drivers are usually permitted to drive as fast as their cars and traffic allow and without being restricted of an official speed limit. So far, this also has been true for using trading venues in Germany. However, the German Government now plans to introduce a "speed limit" for electronic trading on its regulated markets and multilateral trading facilities. A new draft piece of legislation now purports to introduce for the first time a dedicated regulatory framework for algorithmic trading on German trading venues and high frequency traders would be subject to a license requirement with, and supervision by, the German Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht;* "BaFin").

Overview

On July 30, 2012, the German Ministry of Finance presented new draft legislation in the form of an "Act for the Prevention of Risks and the Abuse of High Frequency Trading" (*Entwurf eines Gesetzes zur Vermeidung von Gefahren und Missbräuchen im Hochfrequenzhandel*).[1] The new draft legislation targets the specific risks in connection with computer based algorithmic high frequency trading at German trading venues.

Currently, in Germany there are no specific rules applying to high frequency traders and trading strategies ("HFT") nor, broadly, to algorithmic trading. This is remarkable because algorithmic trading accounts for approximately 50% of the trading volume at Deutsche Börse. Over the last few years in Germany and elsewhere various instances of market glitches and disruptions have been blamed on HFT.

[1] The draft is available at http://www.bundesfinanzministerium.de/Content/DE/Gesetzestexte/Referentenentwuerfe2012-07-30-hochfrequenzhandelsgesetz.html.

In particular, the so-called "flash crash" 0n May 6, 2010, in which the S&P 500 lost and regained, within minutes, approximately 10% of its value, has been partially attributed to the effects of HFT. This fuelled attention in the German media and led to the call for tougher regulation of HFT.[2]

Some of these concerns are already addressed by the proposed reform of the Markets in Financial Instruments Directive ("MiFID II")[3], which introduces a licensing requirement for HFT firms and a specific regulatory framework for algorithmic trading activities.[4] However, Germany is acting ahead of MiFID II. On June 28, 2012, the German Government decided on the needcertain cornerstones for new national legislation targeting HFT and the Ministry of Finance has published draft legislation only one month later. The draft legislation introduces, for the first time, a dedicated regulatory framework for HFT, including a requirement for licensing as a financial services institution (*Finanzdienstleistungsinstitut*) under the German Banking Act (*Kreditwesengeetz*, KWG). There will be new compliance requirements for HFT set-out in the German Stock Exchange Act (*Börsengesetz*) and the German Securities Trading Act (*Wertpapierhandelsgesetz*).

Interested parties may submit comments on the draft legislation by August 17, 2012. The new rules could be finalized and come into force as early as the end of this year.

Licensing Requirement for High Frequency Traders

Under the current regulatory framework applicable in Germany (mostly derived from the MiFID I and mirrored in other EEA countries), 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.

MiFID II proposals require member states to introduce a licensing obligation for certain proprietary trading which will be characterized as an investment service (Annex 1, A No. 3 MiFID II) and limits the exemption for pure proprietary trading without a service component so that it no longer applies to companies which are members or participants of a regulated market or multilateral trading facility ("MTF") (Art. 2(1) lit. d) (ii) MiFID II).

Under the German draft legislations there is an extended definition of proprietary trading which provides that 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 triggers a license requirement as a financial services institution (*Finanzdienstleistungsinstitut*) under the German Banking Act.

The new license requirement is intended to create a level playing field for all trading firms and will enable prudential supervision of HFT firms for the first time. As the proposal is currently worded, it is not clear whether the new rules also cover HFT firms that are not a member of the trading venue, but access the trading venue through "sponsored access" or

[2] *Cf.* the joint report of the US Commodity Futures Trading Commission and the US Securities and Exchange Commission on the findings regarding the market events of May 6, 2010 available at http://www.aima.org/en/regulation/markets-regulation/high-frequency-trading/flash-crash.cfm.

[3] Proposal for a directive of the European Parliament and of the council on markets in financial instruments repealing Directive 2004/39/EC of the European Parliament and of the Council, COM(2011) 656 final.

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

“direct market access” solutions. Credit institutions and financial services institutions which have already been licensed for proprietary trading under the German Banking Act will not have to expand or vary their existing licenses.

Regulation and Supervision as Financial Services Institutions

As financial services institutions, HFT firms will be subject to the general regulatory framework applicable to investment firms under the German Banking Act and the German Securities Trading Act. This includes, among other requirements, a minimum initial regulatory capital requirement of EUR 730,000 and ongoing minimum regulatory capital requirements, comprehensive obligations with respect to organizational and risk management matters, fit and proper requirements for its management and qualifying shareholders, and a multitude of reporting and disclosure requirements. HFT firms will be subject to supervision by BaFin and to BaFin’s enforcement powers under both Acts.

Specific Organizational Requirements for Firms Engaged in Algorithmic Trading

Investment firms (*Wertpapierdienstleistungsunternehmen*), management companies (*Kapitalanlagegesellschaften*) and investment companies (*Investmentaktiengesellschaften*) that are engaged in algorithmic trading would be subject to specific organizational requirements. For this purpose, the draft legislation defines algorithmic trading as trading in financial instruments in such a way that a computer algorithm determines the different parameters for orders automatically. The regime does not apply if the system is only used for the forwarding of orders to one or more trading venues or for the confirmation of orders. The parameters of orders include the timing, price and quantity of the order and details of how an order is executed with limited or no human involvement.

A firm engaged in algorithmic trading must organize its trading systems in such a way that market distortions cannot occur. This includes system and risk management procedures to ensure that:

- the trading system is resilient, has sufficient capacity and appropriate trading thresholds and limits,
- the submission of erroneous orders is prevented and the system otherwise functions in a way that prevents the creation of or perpetuation of a disorderly market, and
- the trading systems cannot be used for trading in violation of the European or national market abuse rules or the rules of the trading venue with which it is connected.

A firm engaged in algorithmic trading must have effective business continuity systems to address unforeseen disruptions in its trading systems and shall ensure that its systems are fully tested and properly monitored. In addition, any change to its computer algorithms must be documented.

These proposed rules are mostly in line with the proposed Art. 17(1) MiFID II. These rules will create substantial challenges for firms to ensure compliance and bring their current systems and procedures into line with the new requirements.

Adequate Ratios Between Sale and Purchase Orders and Executed Transactions

The draft legislation introduces “quote-to-buy” ratio requirements for the ratio between orders and transactions. Trading participants will be obligated to ensure an adequate ratio between their purchase and sales orders and transactions which are actually executed. The purpose of this rule is to avoid “quote stuffing” and other behaviors that clog up trading systems and impede orderly, trading and price discovery. Trading participants will have to establish the ratio for each financial instrument on the basis of the orders and transactions executed within a month period. The order/transaction ratio is adequate if it is “economically reasonable” (*wirtschaftlich nachvollziehbar*) in light of the liquidity of the financial instrument, the specific market situation or the business of the company itself. The Exchange

Rules (*Börsenordnung*) must further specify for certain types of financial instruments the conditions under which an order/transaction ratio is "economically reasonable". MTFs must also prescribe adequate order/transaction ratios.

The new rules try to address trading strategies that swamp the trading system with a high number of orders, where many of these orders are subsequently withdrawn or cancelled, often within less than a second (so-called flash orders). Such trading strategies may be used to test market pricing and liquidity, and to direct the quotation of a financial instrument in a certain direction with a view to profiting from such changes. Even without a manipulative intent, such trading strategies could have a negative impact on market integrity, market stability and resilience.

Given the lack of clear and definitive standards for what amounts to an "economically reasonable" ratio between orders and executed transactions, there will undoubtedly be variations between different trading venues and financial istruments.

Exchanges and MTFs must provide for separate fees in case of excessive usage, in particular in the case of an inappropriately high number of cancelled orders compared to executed trades. In this context, this follows the approach of Deutsche Börse's punitive fee tariff approach. Certain exchanges have sought to restrict high order-to-trade behaviors using punitive fee tariffs (*e.g.*, Deutsche Börse, LSE, Euronext, ICE).

Circuit Breakers

Exchanges and MTFs have to introduce adequate precautions to ensure that the orderly fixing of quotations is also possible in the event of substantial volatility. This includes short term circuit breakers taking into account statistical or dynamic price corridors or limit systems. The introduction of circuit breakers is evidently a reaction to the experience of the May 2010 flash crash and was also recommended by the IOSCO Consultation Report of July 2011.[5]

Minimum Tick Size

Exchanges and MTFs will be obliged to provide an adequate minimum tick size for all traded financial instruments, *i.e.* the smallest possible change between two quotations, in order to prevent a negative impact on the market integrity and liquidity. While small tick sizes principally have their benefits for trading participants and are a sign of efficient markets, they have frequently been used by HFT firms to artificially "outprice" investors with less sophisticated trading infrastructure.

Increased Enforcement Powers of Stock Exchange Supervisory Authorities and BaFin

The competent exchange supervisory authority (*Börsenaufsichtsbehörde*), the Trading Surveillance Office (*Handelsüberwachungsstelle*) and BaFin may request from trading participants engaged in algorithmic trading information on their algorithmic trading activities, including the systems used, details of the algorithmic trading strategies and details of applicable trading parameters and limits. These new information requirements will allow regulators to identify abusive trading strategies. In addition, BaFin may request information on risk management and organizational procedures. To prevent violations against trading laws or to counteract undesirable developments (*Missstände*), the exchange supervisory authority may prohibit particular algorithmic trading strategies. In contrast to

[5] Technical Committee of the International Organization Securities Commissions (IOSCO), Regulatory Issues Raised by the Impact of Technological Changes on Market Integrity and Efficiency, Consultation Report, July 2011.

the proposed Art. 17(2) MiFID II, the German draft legislation does not create regular reporting requirements for algorithms which firms use.

Specific Definitions for Market Abuse

Certain HFT strategies will in the future fall under the revised market abuse rules. Purchase or sale orders which are entered through a computer algorithm that automatically determines the orders' parameters, and which have not been placed with a genuine intention to trade but instead to disrupt or delay the functioning of trading systems, which make it more difficult for other persons to identify genuine purchase or sale orders, or which create a false or misleading impression about the supply and demand for financial instruments, are specifically captured as market abuse under the German Securities Trading Act.

The new rules are identical to Art. 8(3) lit. (c) of the proposed EU Regulation on Insider Dealing and Market Manipulation.[6] In this context, firms engaged in algorithmic trading on German trading venues should be prepared for the regulators in Germany to heighten their monitoring and scrutiny of trading strategies from a market manipulation perspective.

Timing

While the draft legislation is still at an early stage, the German Ministry of Finance has set the deadline for written comments for August 17, 2012, after which the legislation will enter into the parliamentary process. We understand that the German Government envisages that the new legislation will be adopted after the summer break. The legislation will come into force immediately after its publication in the Federal Gazette. Thus, it may come into force as early as the third or fourth quarter of 2012. This is an extremely ambitious timeline given the legislation's far-reaching impact on business models of HFT firms and the need for HFT firms to apply for a license as a financial services institution with BaFin.

The current draft provides for a grandfathering provision, under which companies that become financial services institutions as a result of the new rules are temporarily deemed to be licensed if they apply for a license within three months after the new legislation has come into force. This timeframe is tight for preparing a proper and complete license application.

Impact and Outlook

Most market participants will agree that high frequency traders and their trading strategies require much more regulatory attention and oversight than in the past. This was also the conclusion of the IOSCO Consulation Report, which received substantial support from the industry and market participants. The new draft legislation addresses many of the regulatory methods and approaches outlined and addressed in the IOSCO Consultation Report of July 2011 and envisaged by MiFID II, although it should also be noted that the recommendations of the IOSCO Consulation Report are, in many respects, wider in scope than the proposed draft legislation. It should be noted that the German legislator is refraining from potential drastic measures, such as the introduction of a minimum latency requirement, which would have destroyed the business model of many HFT firms and would likely have had severe consequences on liquidity at German trading venues.

[6] COM(2011) 651 final.

It is as much surprising as questionable that Germany has decided not to wait for a common European solution given that the MiFID II proposals are already at a fairly advanced stage. Instead, Germany appears to opt – not for the first time – for a national solution that precedes and pre-empts legislation at an EU level. Germany recently applied the same strategy with respect to the prohibition of naked short selling and disclosure requirements for short selling. This resulted in the need for several subsequent revisions of the applicable national rules within a short timeframe and created (and is still creating) much confusion and considerable costs for market participants without any clear benefit for market integrity and efficiency.

The deadline for comments on the new draft legislation of just over a fortnight from its publication is extremely short and leaves little room for the industry and market participants to influence matters further. This makes it even more important for firms engaged in algorithmic trading at German trading venues swiftly to analyze the impact of the draft legislation on their business models and practices and decide whether and how these can be brought in compliance with the new legislation – and to lobby for any necessary and/or desirable revisions.

HFT firms should closely monitor the development of the proposed legislation. It may well be that the proposed legislation will be subject to changes and clarifications during the parliamentary procedure. If the new legislation will be adopted as envisaged by the German Government, HFT firms that wish to continue trading on German trading venues will need to react quickly and prepare for a license in Germany or cease trading at German trading venues. Alternatively, it may be worth examining whether an existing MiFID license could be passported into Germany. All firms engaged in algorithmic trading at German trading venues need to review and adapt their organizational and risk management procedures to bring them into line with the new requirements. Training of personnel, surveillance and developing a culture of compliance will be crucial to avoid trading practices that may subsequently be perceived as market manipulation, and consequential investigations, fines and penalties. As the new draft legislation relies in several respects, this will create substantial challenges for trading venues, investment firms and their trading and compliance departments.

For German trading venues, Germany's approach could mean that some HFT firms may avoid the need for getting licensed in Germany and retreat from the German market. This could result in less liquidity on German trading platforms. On the other hand, as a result of the new legislation, German trading venues may also become more attractive for "ordinary" market participants as the new legislation will lower the risk that trading participants will be "out-traded" by HFT firms or that their trading practice will negatively influence market integrity and efficiency.

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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