24 October 2013

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DG Internal Market & Services
European Commission
1049 Brussels
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Dear Mr Faull

ISSUE 180: High Frequency and Algorithmic Trading

MiFID II and MAR – points concerning algorithmic and high frequency trading

As you know, the role of the Financial Markets Law Committee (the "FMLC" or the "Committee") is to identify issues of legal uncertainty, or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks, and to consider how such issues should be addressed.

The FMLC has previously published comments regarding MiFID II, MiFIR and MAR.[1] More recently, the Committee has been made aware of points of ambiguity in proposals for MiFID II and MAR which relate specifically to algorithmic trading and high frequency trading.

The FMLC takes the view that the presentation, in brief terms, of these ambiguities may make a contribution to legal clarity and certainty. To that end, please find in the enclosed appendix a list of points.

I and members of the Committee would be delighted to meet you to discuss the list further. Please do not hesitate to contact me to arrange such a meeting or should you require further information or assistance.

Yours sincerely

Joanna Perkins
FMLC Director

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[1] Proposal for a Directive of the European Parliament and of the Council on markets in financial instruments (Recast) ("MiFID II"); proposal for a Regulation of the European Parliament and of the Council on markets in financial instruments ("MiFIR"); and proposal for a Regulation of the European Parliament and of the Council on insider dealing and market manipulation ("MAR").

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APPENDIX
FINANCIAL MARKETS LAW COMMITTEE
ISSUE 180:[1] ALGORITHMIC AND HIGH FREQUENCY TRADING
24 October 2013

In respect of each point set out below, the provision or provisions concerned and the ambiguity identified are set out in full. The impact of the ambiguity and a proposed solution are set out where available.

1. The meaning of "market manipulation"

1.1. Provision concerned:

- Article 8(3)(c) of the text of the proposal for a Regulation of the European Parliament and of the Council on insider dealing and market manipulation, adopted by the European Parliament at first reading on 10 September 2013 ("MAR"), stipulates that certain market behaviours are to be classified as manipulative:

> "3. The following behaviour shall, *inter alia*, be considered as market manipulation:
>
> […]
>
> (c) the placing of orders to a trading venue, including any cancellation or modification thereof, by any available means of trading, including electronic means, such as algorithmic and high frequency trading strategies, and which has one of the effects referred to in paragraph 1, point (a) or point (b), by:
>
> - disrupting or delaying the functioning of the trading system of the trading venue or which is likely to do so;
> - making it more difficult for other persons to identify genuine orders on the trading system of the trading venue or which is likely to do so, including by entering orders which result in the overloading or destabilisation of the order book; or
> - creating or being likely to create a false or misleading signal about the supply of or demand for, or price of a financial instrument, in particular by entering orders to initiate or exacerbate a trend."

1.2. Ambiguity identified:

- Article 8(3) sets out activities (in addition to those listed in Article 8(1)) which constitute market manipulation. Subparagraph (c) of the article states that the activity of placing orders, including by electronic means "such as algorithmic and high frequency trading strategies", constitutes market manipulation. It is

[1] The FMLC is very grateful to Sam Tyfield of Vedder Price LLP and Karen Anderson of Herbert Smith Freehills LLP for their contributions to this appendix.

inferred that the intention behind the subparagraph is to ensure that firms which do not fall squarely within the meaning of algorithmic and high frequency trading are, nonetheless, captured by MAR's "market manipulation" provisions. This is not entirely clear, however.

1.3. Impact of ambiguity:
- Activities which the legislators intend to be classed as "market manipulation" may not clearly be captured by the provision.

1.4. Proposed solution:
- If the legislative intention is to include activities which otherwise might not be captured by "market manipulation", the words "such as" should be followed by the words "but not limited to".

2. Meaning of "initiate or exacerbate a trend"

2.1. Provision concerned:
- Article 8(3)(c) of MAR. *See section 1 above.*

2.2. Ambiguity identified:
- The activity described in the provision constitutes "market manipulation" only if it gives rise to one of the effects set out in the three sub points to the provision. The third of these is that the activity creates, or is likely to create, a false or misleading signal by entering orders to "initiate or exacerbate a trend". The phrase "initiate or exacerbate a trend" covers a range of market activities which the FMLC is given to understand are normal market practice. For example, firms may use dark pools because they wish to avoid a given order having an initiatory or exacerbatory effect on the market.[2] Conversely, the bringing of (often large block) orders from dark pools onto the lit market may well "initiate or exacerbate a trend" because the market will become aware of large trades. It is inferred that such established market practices are not within the legislative intent of the provision.

2.3. Impact of ambiguity
- The effect of this ambiguity may be unintentionally to capture established market practices.

2.4. Proposed solution
- The European Securities and Markets Authority ("ESMA") should be empowered to produce guidance on this issue.

3. Establishing "accepted market practices"

3.1. Provision concerned:
- "Market manipulation" is initially defined in Article 8(1)(a) of MAR:

> "1. For the purposes of this Regulation, market manipulation shall comprise the following activities:
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> (a) entering into a transaction, placing an order to trade or any other behaviour which:

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[2] A dark pool can be described as a network that allows members to buy and sell large orders without pre-trade price transparency.

- gives, or is likely to give, false or misleading signals as to the supply of, demand for, or price of, a financial instrument or a related spot commodity contract; or
- secures, or is likely to secure, the price of one or several financial instruments or a related spot commodity contract at an abnormal or artificial level;

unless the person who entered into the transactions or issued the orders to trade establishes that his reasons for so doing are legitimate, and that these transactions or orders to trade are in conformity with accepted market practices; or"

3.2. Other provisions concerned:

- The final paragraph of the extract quoted above creates a safe-harbour for "accepted market practices". These are the subject of further definition in Article 5(4a):

"'accepted market practices' means specific market practices that are accepted by the competent authority of a given Member State in accordance with Article 8a of this Regulation."

- The provision cross-refers to Article 8a of MAR, which provides for the processes to be followed in establishing an accepted market practice:

"[…]

2. Competent authorities shall be able to establish an accepted market practice taking into account the following criteria:

(a) the specific market practice has a substantial level of transparency to the market;

[…]

A practice that is accepted in a particular market shall not be considered applicable to other markets unless the competent authorities of such other markets have officially accepted that practice.

[…]

4. […] ESMA shall issue an opinion to the competent authority in question assessing the compatibility of each accepted market practice with the requirements established in paragraph 1 and specified in the regulatory technical standards adopted pursuant to paragraph 7. […]

[…]"

3.3. Ambiguity identified:

- The process for establishing what is an "accepted market practice" for the purposes of applying the safe harbour in this Article creates uncertainty. "Accepted market practice" is defined in Article 5(4a) of MAR by reference to Article 8a. That Article sets out, amongst other things, seven criteria against which a market practice must be tested, rules for informing ESMA and a requirement that the relevant national authority officially accepts a practice before it becomes "accepted" in their Member State (*see extract above*). The seven criteria concern (*inter alia*) the transparency of the practice, its effect on liquidity, its effect on market integrity and its compliance with rules, such as those concerning market abuse. This complex and detailed procedure may prove difficult to carry out. National competent authorities—with a dominant role in the process—may find it difficult to acquire the knowledge or expertise necessary to establish accepted practices.

3.4. Impact of ambiguity:

- The result may be that no accepted market practices will be established for the majority of trading venues. This is unlikely to be the intended consequence of the provision in question.

3.5. Proposed solution

- Article 8a should be amended to simplify the process for establishing accepted practices.

4. The role of market participants in considering whether transactions or orders to trade represent market manipulation

4.1. Provision concerned:

- The Annex of MAR, part A provides a list of considerations to be taken into account for the purposes of identifying "market manipulation" under Article 8(1)(a):

> "A. Indicators of manipulative behaviour related to false or misleading signals and to price securing
>
> For the purposes of applying point (a) of paragraph 1 of Article 8 of this Regulation […] the following non-exhaustive indicators shall be taken into account […] by market participants and competent authorities:
>
> (a) the extent to which orders to trade or transactions undertaken represent a significant proportion of the daily volume of transactions in the relevant financial instrument […] in particular when these activities lead to a significant change in their prices;
>
> […]
>
> (d) the extent to which orders to trade given or transactions undertaken or orders cancelled include position reversals in a short period and represent a significant proportion of the daily volume of transactions in the relevant financial instrument […] and might be associated with significant changes in the price of a financial instrument […];

[…]"

4.2. Ambiguity identified

- The Annex includes a test of the extent to which orders to trade, transactions undertaken—or, for the purposes of paragraph (d), orders cancelled—represent a significant proportion of the daily volume of transactions in a given financial instrument. This forms part of an indicator that certain behaviour is manipulative (the "Significant Proportion Test"). Unlike the equivalent provision in the existing market abuse regime,[3] the test is not tied to the relevant market concerned. It seems unlikely that a trading venue, broker or trading firm will have the information necessary to apply the new test because they will not be aware of all of the transactions in the relevant financial instrument.

4.3. Impact of the ambiguity:

- A trading venue, broker or trading firm without full knowledge of the transactions undertaken in a financial instrument will not be able to apply effectively the Significant Proportion Test and will, therefore, not know what weight to place on the indicator.

4.4. Proposed solution:

- It is important to clarify how the daily volume (for the purposes of the Significant Proportion Test) is to be established, whether this is to be done by reference to the market concerned or to all trading in the relevant financial instrument. Given constraints on the availability of information, it would seem sensible for the test to be tied to the relevant trading venue.

5. The meaning of managing "the order after its submission"

5.1. Provision concerned:

- Article 4(2)(30) of the General Approach of the Council of the European Union on the proposal for a Directive of the European Parliament and of the Council on markets in financial instruments (Recast), dated 18 June 2013 ("MiFID II"), defines "algorithmic trading":

> "'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;"

5.2. Ambiguity identified:

- It seems probable that managing "the order after its submission" refers to the cancellation or amendment of an order but this is not clear.

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[3] See Article 4 of Directive 2003/124/EC which implements the existing Market Abuse Directive (Directive 2003/6/EC) which refers to the daily volume of transactions in the relevant financial instrument on the regulated market concerned.

5.3. Impact of ambiguity:

- This phrase forms part of the definition of "algorithmic trading". The rules to which a firm is subject will depend on whether a firm is deemed to be engaged in "algorithmic trading". (Article 17 of MiFID II, for example, places requirements on firms engaged in "algorithmic trading".) Therefore, ambiguities in the definition (such as the one described here) make it difficult for firms to understand to which regulatory rules they are subject.

5.4. Proposed solution:

- ESMA should be empowered to produce guidance on this issue.

6. The meaning of determining matters with "limited or no human intervention"

6.1. Provision concerned:

- Article 4(2)(30) of MiFID II. *See section 5 above.*

6.2. Ambiguity identified:

- The broad meaning of this phrase appears fairly clear on its face—it refers to a situation in which computers control aspects of trading without human control. Nevertheless, it seems likely that the intention is to capture some situations in which (particularly in the context of market making strategies) regular, periodic, intra-day human intervention will still take place. It is not clear whether such intervention constitutes more than limited intervention.

6.3. Impact of ambiguity:

- *See section 5 above.*

6.4. Proposed solution:

- ESMA should be empowered to produce guidance on this issue.[4]

7. The meaning of "routing orders"

7.1. Provision concerned:

- Article 4(2)(30) of MiFID II. *See section 5 above.*

7.2. Ambiguity identified:

- The assumption might be made that the term "routing orders" refers only to the process of "smart order routing"[5] but this is not wholly clear.

7.3. Impact of ambiguity:

- *See section 5 above.*

8. The meaning of "high frequency algorithmic trading technique"

8.1. Provision concerned:

- Article 4(2)(30a) of MiFID II classifies certain algorithmic trading as "high frequency" algorithmic trading:

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[4] The FMLC is given to understand that the German Federal Financial Supervisory Authority ("BaFin") has already developed guidance on this point with respect to similar provisions in the Hochfrequenzhandelsgesetz, which was adopted by the German Parliament on 28 February 2013 (the "German HFT Act"), but some uncertainty remains even with respect to those provisions.

[5] Broadly speaking, "smart order routing" means a system intended to track liquidity as it moves from trading venue to trading venue and to determine, on that basis, where to send orders.

"'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."

8.2. Ambiguity identified:
- The FMLC is given to understand that similar wording in the German HFT Act has proved difficult to interpret, necessitating the continuing production of guidance by BaFin.[6] It is inferred that the phrase will give rise to similar uncertainty in European law.

8.3. Impact of ambiguity:
- The rules to which a firm is subject will depend on whether it is deemed to be using a "high frequency algorithmic trading technique" (see, for example, the exemption from MiFID II in Article 2(d) of the Directive, which is dissaplied for firms using a "high frequency algorithmic trading technique"). Therefore, ambiguities in the definition of "high frequency algorithmic trading technique" make it difficult for firms to understand to which regulatory rules they are subject.

9. The meaning of "direct electronic access"

9.1. Provision concerned:
- Article 4(2)(31) of MiFID II defines "direct electronic access":

"'Direct electronic access' means, in relation to a trading venue, an arrangement where a member or participant of a trading venue permits a person to use its trading code so the person can electronically transmit orders relating to a financial instrument directly to the trading venue. This definition includes such an arrangement whether or not it also involves the use by the person of the infrastructure of the member or participant, or any connecting system provided by the member or participant, to transmit the orders;"

9.2. Ambiguity identified:
- It is not clear whether the term "direct electronic access" covers "sponsored access" and "direct market access", two distinct types of market arrangement.[7] "Sponsored access" and "direct market access" arguably have different

6 See definitions in footnote 4 above.

7 The FMLC is given to understand that equivalent provisions in the US apply only to "direct market access" arrangements.

characteristics in terms of risk and management. Their being treated in the same way might, therefore, not be within the legislator's intent.

9.3. Impact of the ambiguity:
- A wider range of arrangements than is intended may be subject to regulatory rules which are applicable to firms providing "direct electronic access".

9.4. Proposed solution:
- If legislators intend to treat both arrangements differently, both terms should be defined explicitly in the text.

10. The meaning of "trading code"

10.1. Provision concerned:
- Article 4(2)(31) of MiFID II. *See section 9 above*.

10.2. Ambiguity identified:
- The inference can be made that "trading code", in the definition of "direct electronic access", applies to a trading ID or a log-in or describes a situation in which orders/trades appear in the name of the provider of the "direct electronic access" service. This is not, however, clear.

10.3. Impact of the ambiguity:
- The phrase forms part of the definition of "direct electronic access". The rules to which a firm is subject will depend on whether it is deemed to be providing "direct electronic access" (Article 17 of MiFID II, for example, places requirements on firms providing "direct electronic access"). Therefore, ambiguities in the definition of "trading code" make it difficult for firms to understand to which regulatory rules they are subject.

11. The meaning of acting on "own account"

11.1. Provision concerned:
- Article 4(2)(5) of MiFID II defines "dealing on own account":

> "'Dealing on own account' means trading against proprietary capital resulting in the conclusion of transactions in one or more financial instruments;"

11.2. Other provisions concerned:
- Various Articles in MAR and Articles elsewhere in MiFID II.

11.3. Ambiguity identified:
- The term "dealing on own account" is defined in Article 4(2)(5) of MiFID II in such a way that it appears to capture market making.[8] Given, in particular, that there is a specific exclusion for market makers from the exemption applicable to those dealing on own account in Article 2(1)(d) of the Directive, it is not clear that the definition of "dealing on own account" is intended to cover market making.[9]

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[8] The definition of "market maker" (Article 4(2)(6)) also makes reference to a firm which deals on own account.

[9] More generally, it is noted that the term acting on "own account" bears further elaboration. The FMLC has been given to understand that a similar term in the German HFT Act has given rise to uncertainty. The FMLC understands that BaFin has said that the question as to whether an investment firm or fund manager is acting on

- It may be inferred that the same or similar terms—which appear in MAR and elsewhere in MiFID II, and which are not defined—also cover market making.[10]

11.4. Proposed solution:

- If the term is not intended to cover "market making", clarity would be increased by making this explicit in the definition.

"own account" will have to be determined on a case-by-case basis. Such an ad hoc process makes it difficult for market participants to predict which rules are applicable to them.

[10] It is noted that that the definition of "market maker" in MAR (Article 5(20a)) cross-refers to the definition in the MiFID II.