

August 18, 2011

Guidelines from European Regulator Focus on High Frequency and Algorithmic Trading Obligations

1. Background

On July 20, 2011, the European Securities and Markets Authority (ESMA) issued a consultation paper on systems and controls relating to high frequency trading (HFT) and other forms of automated trading. ESMA is a newly established European authority with the remit to work on and establish legislation and regulation in the EU to standardize markets and monitor/resolve systemic risks for investors and market participants. More information can be found [here](#).

“Consultation on the Guidelines on systems and controls in a highly automated trading environment for trading platforms, investment firms and competent authorities” (the Consultation) sets out ESMA’s proposals for detailed guidelines for trading platforms, investment firms and regulators to address HFT and other challenges of a highly automated trading environment. ESMA states that the guidelines are intended to clarify the obligations of trading platforms and investment firms under the existing EU legislative framework (i.e., where no legislative changes are required). It believes that the proposed guidelines “contribute to the efficiency, orderly functioning and resilience of trading in a highly automated environment.” The Consultation follows on from certain of the issues addressed in the April 2010 calling for evidence by CESR (ESMA’s predecessor) on micro-structural issues of the European equity markets. This sought information on HFT, sponsored access (SA), co-location services, fee structures, tick size regimes and indications of interest.

The Consultation sets out and explains the draft guidelines on requirements that are considered to be relevant in a highly automated trading environment for electronic trading systems, fair and orderly trading and dealing with market abuse (in particular market manipulation). There are separate standards in each of these areas for trading platforms (which includes both regulated markets and multilateral trading facilities) and investment firms executing orders on behalf of clients and/or dealing on their own account. The final section sets out and explains the draft guidelines covering direct market access (DMA) and SA. While the terms “DMA” and “SA” both are used in the Consultation (and in this Advisory as a result), in practice there is no real distinction between the two.

The guidelines are separate from the work the European Commission is conducting in related areas as part of its proposals to revise the EU Markets in Financial Instruments Directive (MiFID). Therefore, while the Consultation relates to EU-regulated markets and MTFs, and firms authorized and regulated by one or more EU regulators, the issues it raises (and the guidelines proposed) are relevant to all HFT or algorithmic traders. Recent IOSCO and other non-EU regulators’ releases, for example, have focused on similar concerns.

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The Consultation does not propose guidelines for co-location, fee structures or tick sizes, since these topics do not relate directly to systems and controls.

2. Summary of the Guidelines

This Advisory provides a summary of the guidelines that we believe to be of particular importance. The guidelines are wide in scope and cover compliance obligations, risk management systems, the development and testing of strategies and trading platforms, and clearance and settlement, among other things, and are expressed to constitute a minimum standard of policies/procedures. Our summary does not include every guideline and we urge clients affected by the guidelines to read the Consultation.

It is our view that the training of personnel and the clear separation of roles for certain functions within a firm will become more important. As well, there are significant areas where regulators will expect firms to have written procedures and controls for compliance and financial risk. These written procedures and controls will be subject to scrutiny by regulators and other firms (e.g., trading firms that have DMA will need to make information available to the firm providing such access) in the future. Finally, firms must be prepared to demonstrate that they have a rigorous testing for trading systems and algorithms in a test environment.

Katten's Proprietary Trading Practice (PTP) is preparing with its clients a number of policies/procedures that are designed to satisfy the guidelines. The firm also can provide training on preventing market abuse and market manipulation and maintaining orderly/fair markets, as well as assistance on any particular platform rules.

3. The Guidelines

Not all guidelines for trading platforms apply to investment firms. Please note that we have highlighted where the guidelines under each of paragraphs 3.1, 3.2 and 3.3 below apply to both trading platforms and investment firms.

3.1 Organizational requirements for electronic trading systems

(a) Trading platforms

Trading platforms should:

- design and monitor electronic trading systems such that they “embed” compliance and risk management in the automated systems, and there should be an approval and “sign-off” process for deployment of the strategies (the Compliance Requirement);
- design electronic trading systems with sufficient capacity (including scalability) to accommodate rising order flow and emergency conditions (the Capacity Requirement);
- develop effective business continuity arrangements (the BCP Requirement);
- monitor electronic trading platforms in real time so that problems can be addressed in an orderly manner (including shutting down the electronic trading system) (the Monitoring/Shut-Down Requirement);
- have sufficient number of properly trained staff to manage electronic trading systems (the Resources Requirement);
- keep written records of their processes/procedures in relation to the above (the Record Requirement); and
- inform competent authorities of significant incidents that may affect the matters referred to above (the Notification Requirement).

(b) Investment firms

Investment firms should:

- comply with the Compliance Requirement, the Capacity Requirement, the BCP Requirement, the Monitoring/Shut-Down Requirement, the Resources Requirement, the Record Requirement and the Notification Requirement;
- use “clearly delineated” development and testing methodologies to confirm the firm’s compliance with MiFID prior to deploying or updating an electronic trading system or algorithm and test the system/algorithm to ensure that it can “continue to work effectively in stressed market conditions”;

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- adopt a testing regime for the algorithms that is commensurate with the risks the strategy may pose to the firm as well as the fair and orderly function of the markets; such testing should be outside the live trading environment and firms should take care to roll out new (or changes to) algorithms in a controlled manner; and
 - review periodically the governance, accountability and sign-off framework for the Compliance Requirement and the BCP Requirement.

3.2 Organizational requirements to promote fair and orderly trading

(a) Trading platforms

Trading platforms should:

- embed the ability to prevent in whole or in part the access of a member or participant to the platform and to cancel, amend or correct a transaction, prior to deploying or updating the electronic trading system or algorithm;
- have arrangements to prevent “flooding” of the order book or capacity limits being breached (by slowing down order flow);
- have arrangements to prevent or constrain trading in individual or multiple financial instruments on both an automatic or discretionary basis in order to maintain an orderly market;
- confirm that all participants’ systems have a minimum functionality level that is compatible with fair and orderly trading;
- have minimum requirements for pre- and post-trade controls, in particular, requirements for filtering order price and quantity;
- have standards covering the knowledge of persons within participants that will be using order entry systems; and
- have the ability to obtain information from participants regarding their compliance with the rule and procedures of the platform.

(b) Investment firms

Investment firms should:

- have systems that automatically block or cancel orders (i) that do not meet price or size parameters, (ii) where client does not have adequate funds to complete the transaction, (iii) if they are for a financial instrument that a trader does not have permission to trade, or (iv) where they risk compromising the firm’s own risk management and/or capital adequacy thresholds;
- have systems in place to override the automatic blocking of orders by pre-trade controls provided that compliance and risk management staff are aware of such override and have given their approval;
- confirm adequate training for staff in order entry procedures before they are allowed to use the order entry systems;
- have close to real-time compliance monitoring of order flow;
- have control of messaging traffic to individual platforms to prevent overcrowding; and
- have appropriate and proportionate governance arrangements, internal controls and reporting systems.

3.3 Organizational requirements to prevent market abuse/manipulation

(a) Trading platforms

Trading platforms should:

- have adequate systems (including automated alerts) to accommodate high frequency generation of orders and transactions and low latency transmission, in order to monitor (using sufficient time granularity) orders and transactions undertaken by participants that may involve market abuse/manipulation (the Monitoring Requirement);
- confirm that those systems referred to above provide the ability to trace backwards transactions as well as orders entered/cancelled;
- have sufficient staff with responsibility for, and understanding and skill to monitor, trading activity and identify behavior giving rise to suspicions of market abuse (the Abuse/Manipulation Resources Requirement); and
- conduct and document periodic reviews and audits of the processes/procedures above.

(b) Investment firms

Investment firms should:

- comply with the Abuse/Manipulation Resources Requirement and the Monitoring Requirement;
- have arrangements to identify transactions that require a suspicious transaction report to a competent authority and make those reports “without delay”; and
- conduct and document periodic reviews and audits of the above.

3.4 Organizational requirements for DMA/SA

(a) Trading platforms

Trading platforms should:

- make the investment firm providing DMA/SA (the Sponsor) responsible for all orders entered under its trading code;
- require the Sponsor to conduct due diligence on any client, including on its systems, procedures and controls;
- reserve the right to refuse a request by a Sponsor to allow a client to have SA or to suspend or withdraw SA once it has been granted; and
- reserve the right to stop orders from a participant trading through SA separately from the Sponsor.

(b) Sponsors

Sponsors should:

- have criteria covering (i) training and competency of individuals entering orders, (ii) access controls over order entry, (iii) allocation of responsibility for dealing with actions/errors and (iv) financial standing of sponsored participants;
- have clear assessment (with periodic review) procedures of the approval process for and ongoing trading activities of sponsored participant;
- have appropriate credit thresholds for sponsored participants (reviewed periodically);
- have pre-trade controls of the sort set out in paragraph 3.2(b) above;
- reserve the right (in its sole discretion) to modify parameters of pre-trade controls;
- have a real-time feed of orders entered and trading done by sponsored participants pursuant to which those orders can be identified from the orders and trades of other clients of the Sponsor to help identify conduct that may involve market abuse;
- reserve and embed the ability to “immediately halt trading” of a sponsored participant; and
- acquire/license third-party pre- and post-trade controls (unless the Sponsor develops them itself), provided that the Sponsor remains liable for the controls’ effectiveness and their key parameters.

The consultation period ends on October 3, 2011, and ESMA expects to publish its final guidelines before the end of the year. We encourage all parties interested in HFT to respond to the Consultation. Please contact any of the members of the PTP, in particular those listed on this Advisory, if you have any questions concerning the ESMA’s consultation paper.

Click [here](#) to read the consultation paper in its entirety.

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