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MiFID II—How It Affects Proprietary Traders and Algorithmic Traders

Background

The European Commission's final draft proposals for the revised Markets in Financial Instruments Directive (MiFID II) along with a related regulation (MiFIR) were published October 20, 2011. The objective of the original MiFID, which was passed in 2004 and came into force in 2007, was to improve investor protection and promote cross-border market access across the EU. As proposed, MiFID II is designed to further that objective and to address issues which have been exposed by market developments since the onset of the financial crisis from 2008 to date.

Various previous drafts have been leaked and there is not much in the final draft that was not anticipated.

It is to be expected that there will be amendments to MiFID II prior to its final adoption (see below under the heading "European Legislative Process"). Once it is adopted, which likely will be in mid- to late-2012, member states will then be required to implement MiFID II's provisions into their own national laws. The period allowed for this generally is two years after the adoption of a Directive.

For those familiar with the rules coming into force in the US under Dodd-Frank, MiFID II's significant proposals will affect market participants in similar ways. For example, MiFID II proposes that member states impose position limits and position reporting and central clearing for OTC derivatives. ***Above all, regulators and market participants hope that any real or perceived differences between US and EU approaches to regulation and market stability are smoothed out in the forthcoming process.***

Why MiFID II is important

Several proposals in MiFID II relate to or expand on the guidelines set forth in the consultation paper on high frequency trading issued by the European Securities and Markets Authority (ESMA) in July 2011. The consultation period on ESMA's proposal ended earlier this month, and final guidelines are expected by year end. ESMA has described the guidelines as "best practice" but, if adopted as part of MiFID II, they will be binding. A more detailed discussion of ESMA's proposed guidelines is available in Katten's [August 2011 Client Advisory](#) on this subject.

In addition, in its press release, the European Commission stated that MiFID II would "introduce new safeguards for algorithmic and high frequency trading activities which have drastically increased the speed of trading and pose possible systemic risks."

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Current draft proposals for proprietary trading firms

Under current financial services regulations applicable across the EU, firms which trade on their own account, with certain exceptions, do not need to be authorised and regulated. ***Under the draft MiFID II proposals, proprietary trading firms which are direct members of trading venues (which include “Regulated Markets”(RMs), “Multilateral Trading Facilities” (MTFs) and (a new class of venue) “Organised Trading Facilities” (OTFs)) will be required to be authorised and regulated by their home member state. The type and scope of such regulation and authorisation is yet to be determined.***

For the UK at least, this is a reversion to the regulatory principles applicable before the original implementation of MiFID in 2007.

OTFs will be subject to transparency, reporting, best execution and other requirements that are applicable to RMs and MTFs. In addition, however, MiFID II provides that owners and operators of OTFs cannot trade their own capital against the capital of participants in the market. Owners and operators of MTFs (and firms which are “systematic internalisers” (SIs) (i.e., “one-against-many” platforms)) are able to trade their own capital against that of the participants. Whilst SIs are not regulated markets in the same way as MTFs and OTFs, there are other disadvantages for the owners and operators of those platforms, which means that an owner/operator which wishes to trade its own capital may believe that its only option is to become a MTF. However, an MTF itself is subject to restrictions. For example, it cannot opt out of pre-trade price transparency—an option which is available to OTFs (subject to certain approvals).

Current draft proposals for algorithmic trading firms

There has been a significant focus recently on the perceived systemic risks of high frequency and automated trading. We understand from discussions with sources within the UK Financial Services Authority that there was a large amount of negotiation among EU regulators as to what types of automated trading MiFID II should regulate. The draft uses the phrases “automated trading” and “high frequency trading” throughout, but has only one defined term, “Algorithmic Trading”:

“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 purposes of routing orders to one or more trading venues or for the confirmation of orders.”

It is possible that such a definition could include “grey box” as well as “black box” trading. Given the use elsewhere in MiFID II of non-defined terms, the exact scope of the goal in relation to high frequency/automated trading firms remains unclear.

However, the draft proposals make it clear that all Algorithmic Trading firms must, after the implementation of MiFID II, be authorised and regulated by their home member state, whether they are trading as direct members of a trading venue or otherwise.

There is a further provision (which proved controversial in the run-up to the publication of the final draft of MiFID II) which provides that all “algorithmic trading strategies” (undefined) must:

“be in continuous operation during the trading hours of the trading venue to which it sends orders or through the systems of which it executes transactions. The trading parameters or limits of an algorithmic trading strategy shall ensure that the strategy posts firm quotes at competitive prices with the result of providing liquidity on a regular and ongoing basis to these trading venues at all times, regardless of prevailing market conditions.”

MiFID II also provides that member states must require each firm which operates Algorithmic Trading strategies to disclose “at least annually” to its home state regulator “a description of the nature of its algorithmic trading strategies, details of the trading parameters or limits to which the system is subject, key compliance and risk controls that it has in place ... and details of the testing of its systems”. This does not appear to go as far as requiring that traders must disclose their algorithms, but it does indicate the importance of having policies and procedures in place which can be shared with and explained to regulators. This topic was covered in more detail in our previous Advisory on the ESMA guidelines on high frequency trading, as mentioned above.

Although the types of recommendations set out by the international regulatory organisation IOSCO to protect markets and market participants are broadly similar to those set out in MiFID II (e.g., pre-trade transparency (with some exceptions), open and equal access to co-location, circuit-breakers, knowledge of/training in trading strategies and adequate risk monitoring/management systems), since there are differences in approach to the impact high frequency and algorithmic trading has on markets, there may well be further debate on the goals in MiFID II before a final version is adopted.

European legislative process

MiFID II is a “directive.” This is a legislative act that sets out a goal that all EU member states must achieve. How the member states achieve the goal through their own laws and regulations is a matter for their own national legislatures and regulators. There is scope for interpretation and differences in form and substance of final implementation and a delay between passing of a directive and its goals becoming effective and binding. Alongside MiFID II there will be a regulation, MiFIR, which will apply directly as a matter of national law in all EU member states once it is passed, likely to be at the same time as MiFID II.

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