

Financial institutions
Energy
Infrastructure, mining and commodities
Transport
Technology and innovation
Life sciences and healthcare



InfoNet MiFID II/R Seminar Series

Microstructural Issues

Jonathan Herbst

Conor Foley

London, 10 December 2015



Background to MiFID II, MiFIR provisions

HFT – A MiFID political priority

- Ensure all market participants are regulated
- Address fears of ‘flash crashes’, ‘ghost liquidity’ and ‘sophisticated manipulation’
- Keep liquidity providers in the market during periods of price volatility
- Regulate market making

Practical effects

- Article 1(5) MiFID II extends main provisions to unregulated market participants
- Article 2(1) MiFID II changes mean much broader authorisation requirement
- Article 17 MiFID II requirements for all members / participants of RMs, MTFs
- Article 48 MiFID II sets out corresponding requirements for trading venues

Algorithmic trading

“trading where a computer algorithm automatically determines ... parameters of orders such as whether to initiate the order, the timing, price or quantity ... or how to manage the order after submission, with limited or no human intervention”

It does not include:

- route orders to trading venue(s)
- order processing where there is no determination of parameters other than venue
- order confirmation or post-trade processing of transactions

But it does include:

- automated trading decisions and optimisation of order execution by automated means (e.g. smart order routers)
- systems that make independent decisions at any stage (e.g. on initiating, generating, routing or executing orders)

HFATT

High frequency algorithmic trading technique

- Infrastructure that is intended to minimise latencies, including *at least* one of:
 - co-location
 - proximity hosting or
 - high-speed direct electronic access
- System determination of order initiation, generating, routing or execution without human intervention for individual trades or orders; and
- High message intraday rates which constitute orders, quotes or cancellations

Specific requirements

- Article 2(1) MiFID II exclusions;
- Article 17(2) MiFID II order recording.

Delegated Acts (draft)

“High message intraday rate”

- Average of at least 4 messages per second for all instruments traded on a trading venue, or
- At least 2 messages per second for any single financial instrument traded on a trading venue.

Other conditions

- Liquid financial instruments only;
- Includes messages under CQO;
- Proprietary orders only; and
- Any HFATT means person is subject to HFATT-specific requirements.

Direct electronic access

“an arrangement where a member or participant or a client 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 and includes arrangements which involve the use by a person of the infrastructure of the member or participant or client, or any connecting system provided by the member or participant or client, to transmit the orders (direct market access) and arrangements where such infrastructure is not used by a person (sponsored access)”

Delegated Acts

- Critical test: ability to exercise discretion regarding exact fraction of second of order entry and lifetime of orders within that timeframe.
 - ✓ DEA = Access via provider's trading code + AT order router (user-side)
 - ✗ DEA ≠ Access via provider's trading code + AT order router (provider-side)
 - ? DEA =/≠ Access via provider's trading code + non-AT router

Article 17: obligations on investment firms

Article 17(1)

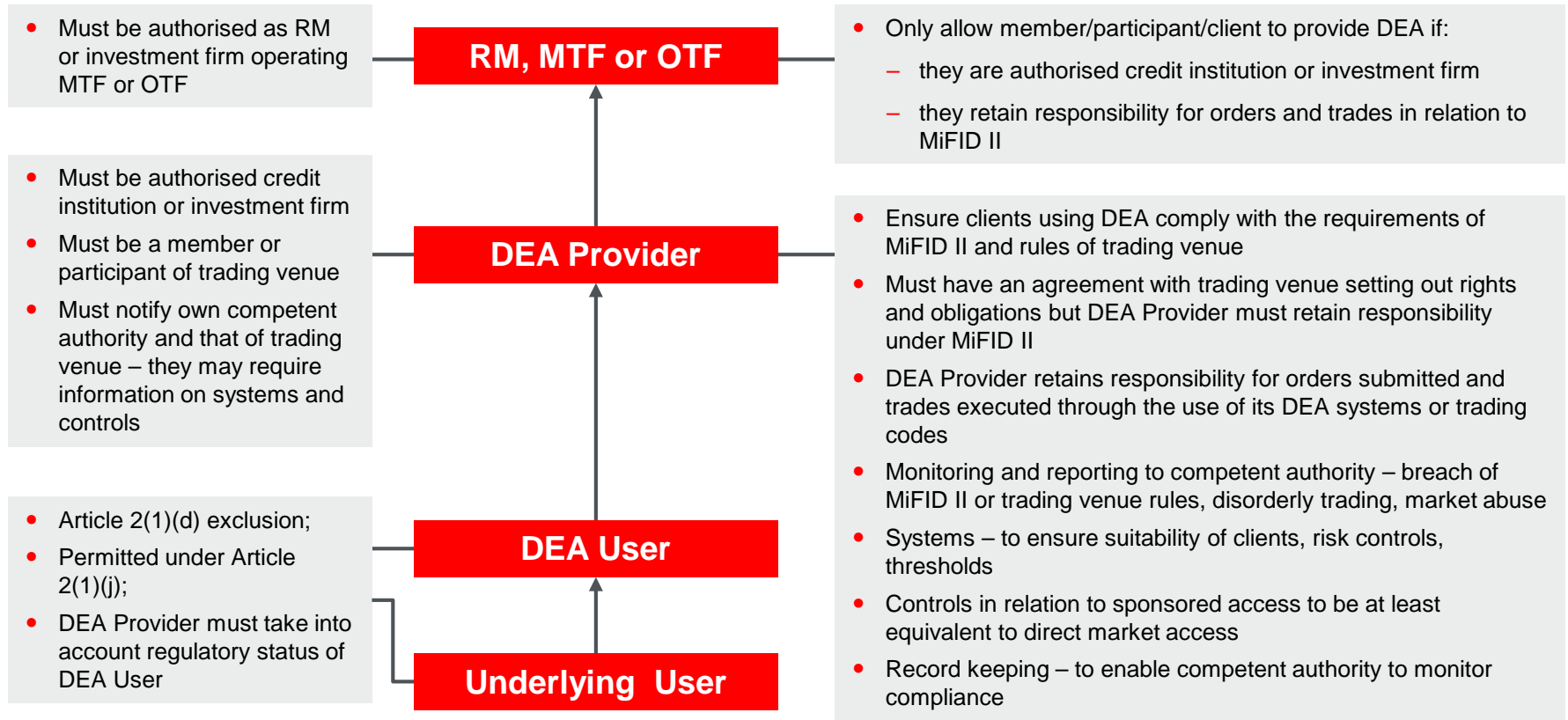
- Effective systems and controls to ensure trading system resilience
- Market abuse controls
- Business continuity arrangements
- Testing and monitoring of systems

RTS 6

- General requirements and proportionality
- Revised requirements for “compliance function”
- Beefed up compliance and risk staff requirements
- Individual responsibility for deployments and algorithm updates
- Revised IT outsourcing and procurement requirements
- Testing environment requirements
- Controlled deployment of algorithms
- Annual self-assessment on specified parameters
- Stress testing
- Kill functionality
- Surveillance requirements
- Business continuity arrangements
- Pre-trade controls on order-entry
- Cyber security testing

Article 17: obligations on investment firms

DEA chain



Article 17: obligations on investment firms

Requirements for general clearing members

GCM

Client due diligence

- Eight (8) minimum assessment criteria
- Annual client review
- Clearing agreement must reference criteria

Trading and position limits

- To manage counterparty, liquidity, operational and “other” risks
- Pre and post-trade risk controls calibrated to limits
- Record of client compliance with trading and position limits

Must disclose

- “General policy” on services offered to clients
- “Levels of protection” and costs of segregating client assets
- Obligation to provide on “reasonable commercial terms”?

Article 17: obligations on investment firms

Market making (re)defined

“as a member of a trading venue, its strategy, when dealing on own account, involves posting firm, simultaneous, two-way quotes of comparable size and at competitive prices relating to financial instruments on trading venues, with the result of providing liquidity on a regular and frequent basis”

Proposed threshold

- At least one financial instrument on one trading venue;
- For at least 50% of the daily trading hours of continuous trading at that trading venue; and
- For over half the trading days over a one month period.

MM requirements

- Enter into agreement with trading venue;
- Competitive quotes;
- CQO: no less than 50% of trading hours; and
- Excluding exceptional circumstances.

Market making schemes

- Certain liquid financial instruments only;
- Continuous auction order book trading;
- Minimum requirements; and
- Fair and non-discriminatory schemes.

Questions

- MMA v MMS
- Stressed market conditions

Article 48: obligations for trading venues

Article 48

- Effective systems and controls to ensure trading system resilience
- Sufficient capacity to deal with peak order and message volumes
- Testing and monitoring of systems
- Business continuity arrangements
- Pre-trade controls
- Fair and transparent rules on colocation services

RTS 7

- Self-assessments
- Governance and risk monitoring requirements
- Testing and monitoring of systems
- Revised requirements for “compliance function”
- Due diligence of prospective members
- Testing requirements
- Business continuity arrangements and business continuity plan
- Review of business continuity arrangements
- Arrangements to prevent disorderly trading and manage volatility
- Pre and post-trade controls
- Specific requirements if permitting sponsored access
- Physical and electronic security arrangements

Article 50: synchronisation of business clocks

Article 50

- Applicable to all trading venues, members/participants/clients
- Clocks used for any “reportable event”
- Synchronisation between trading venues and members/participants/clients

RTS 25

- Coordinated Universal Time (UTC) as basis
- Accuracy: trading venue (depends on speed of trading system)
 - (i) Gateway-to-gateway latency is >1 millisecond
1 millisecond divergence, minimum 1 millisecond timestamp
 - (ii) Gateway-to-gateway latency is ≤ 1 millisecond
1 millisecond divergence, minimum 1 millisecond timestamp
- Accuracy: member/participant/client (depends on trading activity)
 - (i) HFATT
100 microsecond divergence, minimum 1 microsecond timestamp
 - (ii) Activity on voice trading, RFQ systems
1 second divergence, minimum 1 second timestamp
 - (iii) All other unspecified trading activity
1 millisecond divergence, minimum 1 millisecond timestamp

Questions and comments

Jonathan Herbst

Partner, Global Head of Financial Services
Norton Rose Fulbright LLP

T: +44 207 444 3166

M: +44 7734 327987

jonathan.herbst@nortontrosefulbright.com

Conor Foley

Head, Government Relations and Public Policy
Norton Rose Fulbright LLP

T: +44 207 444 5693

M: +44 7740 286 450

E: conor.foley@nortontrosefulbright.com

The logo consists of a stylized, upward-pointing chevron or mountain shape in a gold or tan color, positioned to the left of the text.

NORTON ROSE FULBRIGHT

Disclaimer

Norton Rose Fulbright US LLP, Norton Rose Fulbright LLP, Norton Rose Fulbright Australia, Norton Rose Fulbright Canada LLP and Norton Rose Fulbright South Africa Inc are separate legal entities and all of them are members of Norton Rose Fulbright Verein, a Swiss verein. Norton Rose Fulbright Verein helps coordinate the activities of the members but does not itself provide legal services to clients.

References to 'Norton Rose Fulbright', 'the law firm' and 'legal practice' are to one or more of the Norton Rose Fulbright members or to one of their respective affiliates (together 'Norton Rose Fulbright entity/entities'). No individual who is a member, partner, shareholder, director, employee or consultant of, in or to any Norton Rose Fulbright entity (whether or not such individual is described as a 'partner') accepts or assumes responsibility, or has any liability, to any person in respect of this communication. Any reference to a partner or director is to a member, employee or consultant with equivalent standing and qualifications of the relevant Norton Rose Fulbright entity.

The purpose of this communication is to provide general information of a legal nature. It does not contain a full analysis of the law nor does it constitute an opinion of any Norton Rose Fulbright entity on the points of law discussed. You must take specific legal advice on any particular matter which concerns you. If you require any advice or further information, please speak to your usual contact at Norton Rose Fulbright.