# MiFID II

## Algorithmic trading

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## MiFID II planning and implementation is a top priority for asset managers affected by European regulations and brings with it both challenges and opportunities.

**The Council of the European Union on 13 May 2014 formally endorsed a new regulatory regime that will replace the current Markets in Financial Instruments Directive (MiFID), which has been in force since 2007. The new legislation, in the form of a recast Directive (MiFID II) and Regulation (MiFIR), is scheduled to go into effect on 3 January 2018.**

### Summary of obligations

MiFID II applies systems and governance requirements to firms which engage in "algorithmic trading" and additional requirements for firms utilising "high frequency algorithmic trading" (HFT).

### Scope

"Algorithmic trading" is defined as "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, and does not include any system that is only used for the purpose of routing orders to one or more trading venues or for the processing of orders involving no determination of any trading parameters or for the confirmation of orders or the post-trade processing of executed transactions."

For the purposes of this definition, a system has "no or limited human intervention" where, for any order or quote generation process or any process to optimise order-execution, an automated system makes decisions at any of the stages of initiating, generating, routing or executing orders or quotes according to pre-determined parameters.

"High-frequency algorithmic trading technique" is defined as an algorithmic trading technique characterised by:

– 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.

– System-determination of order initiation, generation, routing or execution without human intervention for individual trades or orders.

– High message intraday rates which constitute orders, quotes or cancellations.

A "high message intraday rate" in this context means the submission on average of any of the following:

– At least 2 messages per second with respect to any single financial instrument traded on a trading venue; or

| 2007 | 2011 | 2014-2015 | 2016 | 3 July 2017 | 3 January 2018 |
|---|---|---|---|---|---|
| MiFID II in force | Proposal for MiFID II | ESMA consults on implementation | MiFID II application delay confirmed | Deadline for incorporation of MiFID II into EU Member State national law | **MiFID II and MiFIR apply** |

- At least 4 messages per second with respect to all financial instruments traded on a trading venue.

## Algorithmic trading obligations

Firms carrying out algorithmic trading are subject to the following obligations. A firm must:

### Systems and controls

- Have in place effective systems and risk controls suitable to the business it operates to ensure that its trading systems are resilient and have sufficient capacity, are subject to appropriate thresholds and limits and prevent the sending of erroneous orders or the systems otherwise functioning in a way that may create or contribute to a disorderly market.

- Have in place effective systems and risk controls to ensure the trading system cannot be used for any purpose that is contrary to market abuse laws or to the rules of a trading venue to which it is connected.

- Have in place effective business continuity arrangements to deal with any failure of its trading systems.

- Ensure that its systems are fully tested and properly monitored.

- Notify its regulator that it is engaging in algorithmic trading and of the trading venue at which the firm engages in algorithmic trading as a member or participant.

The detailed rules supplementing these obligations are set out in Regulatory Technical Standard 6 implementing MIFID II and specify, amongst other things, the role and staffing of the compliance function of firms carrying out algorithmic trading. IT testing requirements and pre and post trade controls.

### Market making

A firm which engages in algorithmic trading to pursue a market making strategy must, taking into account the liquidity, scale and nature of the specific market and the characteristics of the instruments traded:

- Carry out this market making continuously during a specified portion of the trading venue's trading hours, except under exceptional circumstances, with the result of providing liquidity on a regular and periodic basis to the trading venue.

- Enter into a binding written agreement with the trading venue which shall at least specify the obligations of the firm in accordance with the point above.

- Have in place effective systems and controls to ensure that it fulfils its obligations under that binding written agreement.

A firm engaged in algorithmic trading pursues a market making strategy when, as a member or participant of one or more trading venues, its strategy, when dealing on its own account, involves posting firm, simultaneous two-way quotes of comparable size and at competitive prices relating to one or more financial instruments on a single trading venue or across different trading venues, with the result of providing liquidity on a regular and frequent basis to the overall market.

Again, detailed rules supplement these obligations on Regulatory Technical Standard 6

### Regulatory reporting

The regulator may require the firm that engages in algorithmic trading, on a regular or ad hoc basis to provide:

- A description of the nature of its algorithmic trading strategies.

- Details of the trading parameters or limits to which the system is subject.

- The key compliance and risk controls the firm has in place to ensure the conditions in the points above are satisfied.

- Details of testing of its systems.

The FCA is still to confirm if it will apply these obligations in the UK.

## HFT obligations

In addition to the algorithmic trading obligations set out above, firms engaging in HFT must store in approved form accurate and time sequenced records of all its placed orders, including cancellation of orders, executed orders and quotations on trading venues and shall make them available to its regulator upon request.

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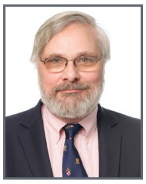


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