The European Guidelines on Systems and Controls for Electronic and Algorithmic Trading

On February 24, 2012, the European Securities and Markets Authority ("ESMA") published guidelines on systems and controls in an automated trading environment for trading platforms, investment firms and competent authorities (the "Guidelines"). The Guidelines interpret existing EU requirements set out in the Markets in Financial Instruments Directive ("MiFID") and Market Abuse Directive. They are intended to come into effect in **May 2012**.

The May 2010 Flash Crash, which affected U.S. and EU security and derivative markets, provided the principal impetus for the Guidelines. However, the substance of the Guidelines moves beyond the Flash Crash to address generally the reliability, compliance, and proper management of electronic trading systems ("ETSs") used to deal in securities, derivatives and other financial instruments, including large scale trading platforms, individual systems used by specific traders, systems used to execute orders, and systems which automatically generate orders, i.e. trading algorithms. The Guidelines will not of themselves have the force of law but they should guide the EU Member State authorities' implementation and enforcement of existing laws and may, therefore, have the same effect as a new law or regulation would have on behavior of market participants.

Who will the Guidelines affect?

- Any fund manager, broker-dealer or investment bank (any "Firm") that is regulated in the EU under MiFID, whether trading for its own account or for clients, which uses an ETS to trade in financial instruments, including securities and derivatives.
- Any EU regulated market ("RM") or multilateral trading facility ("MTF") that operates an ETS located within the EU, which means that Non-EU traders who trade in financial instruments admitted to trading on an RM or traded through an MTF will be subject indirectly to the Guidelines.
- Any Firm that provides clients with direct market access ("DMA") or sponsored access ("SA") to an ETS as part of the Firm's execution of orders on behalf of the clients ("Execution Services").
- Entities that sell ETSs to RMs or MTFs or provide services related to ETSs.
- Entities, such as insurers, which are regulated in the EU but exempt from MiFID.

What do the Guidelines cover?

There are eight sets of Guidelines – four for RMs and MTFs and four for Firms – with the Guidelines for RMs and MTFs and those for Firms covering the same issues:

- General requirements for the proper development, testing, deployment and management of ETSs. This includes the obligation to "embed" appropriate systems for legal compliance and risk management into automated systems, including trading algorithms. The Guidelines define "trading algorithms" as computer software programmed to apply instructions, carry out analyses or apply parameters that generate orders to be submitted to trading platforms automatically in response to market information.
- The promotion of fair and orderly trading in an automated trading environment.
- The prevention of market abuse (in particular market manipulation) in an automated trading environment.
- The provision of DMA and SA.

What do the General Guidelines require for Firms?

- A Firm's ETS must be well adapted to the business which takes place through it, compliant with law, developed and managed through a proper governance system, robust enough to ensure reliable continuity, and supported by appropriate security, staffing and record keeping.
- A Firm must have implemented policies and procedures ("Policies"), including certain policies embedded into the system technology, to ensure that its ETS comply with all applicable legal obligations and that it manages the risks relating to automated trading, taking into account: price or size parameters; permission to trade; risk management; consistency with laws; reporting obligations to competent authorities; overriding of pre-trade controls; training on order entry procedures; monitoring and accessibility of knowledgeable and mandated staff; close scrutiny by compliance staff; control of messaging traffic; management of operational risk; IT compatibility; and record keeping and cooperation.
- A Firm must have Policies to minimize the risk of market abuse. Such policies should seek to detect and prevent, in particular, the following:
  - ping orders (defined by ESMA as "entering small orders in order to ascertain the level of hidden orders and particularly used to assess what is resting on a dark platform");
  - quote stuffing ("entering large numbers of orders and/or cancellations/updates to orders so as to create uncertainty for other participants, slowing down their process and to camouflage [the trader's] own strategy");
  - momentum ignition ("entry of orders or a series of orders intended to start or exacerbate a trend, and to encourage other participants to accelerate or extend the trend in order to create an opportunity to unwind/open a position at a favourable price"); and
  - layering and spoofing ("submitting multiple orders often away from the touch [i.e., market price] on one side of the order book with the intention of executing a trade on the other side of the order book. Once that trade has taken place, the manipulative orders will be removed.").
- The Firm's Policies should at least address: understanding, skill and authority of compliance staff; training in market abuse; monitoring; suspicious transaction reporting; periodic reviews of Policies; recordkeeping; and audit procedures governing staff access to ETSs.
- A Firm that offers DMA/SA must establish Policies to ensure that any DMA/SA related trading complies with the rules and procedures of the relevant RM or MTF to which DMA/SA client orders are submitted, taking account of the following: due diligence on DMA/SA clients; pre-trade controls; "naked" or "unfiltered" market access; monitoring; rights and obligations of the parties to a DMA/SA arrangements and record-keeping.

What is the likely effect of the Guidelines?

The Guidelines continue the regulatory trend in the U.S. and Europe of regulators seeking to extend regulatory infrastructure and practices into the world of technology based trading and Firms. Organizations (including Non-EU traders) dealing on or though regulated markets and multilateral trading facilities in the EU should revisit their Policies in light of the Guidelines. As an embodiment of current best practices, the Guidelines are unlikely themselves to address buy-side concerns about the activities of high frequency traders. Instead, these may be addressed by the current proposals in MiFID 2 covering algorithmic and high frequency trading, which are likely to take effect in or around 2014. On current proposals, MiFID 2 will require high frequency traders to adopt quasi-market making roles and will seek to bring unregulated high frequency traders within the scope of EU regulation.