

REGULATORY UPDATE: GERMAN HIGH FREQUENCY TRADING ACT¹

HEDGE FUNDS

High frequency traders (HFT) account for a large percentage of exchange transactions in developed markets (approximately 70 per cent of all exchange trades in the US, 60 per cent in the UK and 40 per cent in Germany). High frequency trading has received a lot of negative publicity in recent years and is perceived to pose several risks to the financial markets, including having the potential for facilitating market manipulation and the overloading of trading systems.

To address these perceived risks Germany has stolen a march on the EU's plans to impose additional regulation on those engaged in high frequency trading under the MiFID II proposals, by enacting its HFT Act. The stated aims of the HFT Act are to (amongst other things):

- ◆ increase the stability and integrity of the German financial markets;
- ◆ prevent market manipulation by high frequency traders; and
- ◆ protect long-term investors and minimise market risks.

The HFT Act imposes requirements on those engaged in high frequency trading and also those engaged in algorithmic trading. While those engaged in high frequency trading will, once the HFT Act comes into force, be subject to new authorisation requirements, all forms of algorithmic trading activity will be subject to additional reporting and compliance requirements (see further below). The HFT Act also imposes new obligations on trading venues, including requirements to establish appropriate order-to-trade-ratios, minimum tick sizes and flagging of algorithmic orders.

IMPLICATIONS FOR HIGH FREQUENCY TRADERS

High frequency trading is defined by the HFT Act as the “buying or selling of financial instruments on own account as a direct or indirect participant on a domestic organised market or multi-lateral trading facility by means of a high frequency algorithmic trading strategy, characterised by the use of infrastructures whose aim is to minimise latency through the decision of a system regarding initiation, entry, transmission or execution of an order without human intervention in individual transactions or orders, and characterised by a high intraday message rate in the form of orders, quote or cancellations, when not provided as a service to others.”

Firms falling within this definition who are either direct or indirect participants in German markets (either exchanges or multi-lateral trading facilities (MTF) (e.g. Eurex, German regional exchanges, Eurex Bonds) and who trade on own account are required to obtain an appropriate authorisation from the German Federal Financial Supervisory Authority (BaFin) or hold an equivalent authorisation under MiFID in another EU member state together with a passport.

The authorisation requirement under the HFT Act is likely to cause issues for some proprietary traders who are exempt from authorisation under MiFID. Under Article 2(1)(d) of MiFID “persons who do not provide any investment services or activities other than dealing on own account” are exempt from MiFID. A statement of political intention indicates that firms based in the EU who are not authorised under MiFID may still be exempted from the authorisation requirement under the HFT Act if they are “regulated in a way similar to the German authorisation”. While there is no certainty as to how this statement of political intention will be interpreted by BaFin, this may be a route which firms exempted from MiFID yet regulated under national regimes, e.g. “local” firms in the UK, can seek exemption from the HFT Act authorisation requirement. This may also be helpful for branches of third country firms established and authorised under national regimes within the EU (but outside Germany).

The HFT Act will come into force on the day after it is published in German Federal Law Gazette. However, firms located outside of Germany (including those elsewhere in the EU and in third countries) have a transitional period of 9 months from the date on which the HFT Act comes into effect to obtain the appropriate authorisation or passport. Firms engaged in high frequency trading should, therefore, consider whether they have the appropriate authorisation and comply with notification requirements to BaFin in advance of the end of the 9-month transitional period. Bearing in mind that obtaining a new authorisation (where this is necessary) can be a time consuming exercise, high frequency traders would be well-advised to consider this sooner rather than later.

ORGANISATIONAL AND OTHER REQUIREMENTS ON ALGORITHMIC TRADING

Algorithmic trading is defined for the purposes of the HFT Act as “trading in financial instruments through means of a computer algorithm which automatically determines the parameters of orders ... Order parameters are, in particular, the decision to send orders, the timing of orders, price and quantity of the order or how the order should be dealt with once sent”.

¹ The following sets out Macfarlanes' general understanding of the German High Frequency Trading Act. It is not and should not be construed as German legal advice. Should you require legal advice in relation to any aspect of the Act, we would be happy to liaise with an appropriately qualified law firm in Germany for you.

The HFT Act imposes new organisational requirements on all firms engaged in algorithmic trading, including asset management firms. Importantly, the organisational requirements for algorithmic trading firms are not restricted to those engaged in proprietary trading in the way in which the authorisation requirements for high frequency trading firms are. Their scope of application is much wider and will capture asset managers, fund managers, etc. engaged in algorithmic trading within the definition set out in the HFT Act. Firms engaged in algorithmic trading must have systems and risk controls that ensure:

- ◆ its trading systems are resilient, have sufficient capacity and are subject to appropriate trading thresholds and limits;
- ◆ the transmission of incorrect orders or malfunctioning of the system are avoided where these could cause or contribute to market disruption; and
- ◆ its trading systems cannot be used to perpetrate market abuse.

A firm which engages in algorithmic trading must also implement appropriate emergency measures to deal with any disruptions to the trading systems and ensure that systems are tested and monitored. A record of every change made to an algorithm used for trading must also be retained.

We understand that BaFin is currently working on guidance for the industry on some of the terms used, such as "sufficient capacity" and "appropriate trading thresholds and limits".

In addition to the organisational requirements, BaFin is also given additional powers to request information at any time about algorithmic trading strategies and systems and effectively ban algorithmic strategies where BaFin is not satisfied with the strategy.

The same 9-month transitional period will apply for those engaged in algorithmic trading activities and BaFin will not seek to enforce against firms not in full compliance with the new organisational requirements in advance of that date. However, firms engaged in algorithmic trading should assess their systems and algorithms to ensure that they will be in a position to comply with the new organisational requirements by the end of the transitional period (which is expected to be Q1 2014).

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