

Launched in 1960, the European Banking Federation is the voice of the European banking sector from the European Union and European Free Trade Association countries. The EBF represents the interests of almost 5000 banks, large and small, wholesale and retail, local and cross-border financial institutions. Together, these banks account for over 80% of the total assets and deposits and some 80% of all bank loans in the EU only.

EBF Response to ESMA'S Guidelines on systems and controls in a highly automated trading environment for trading platforms, investment firms and competent authorities

Key Points

- 1. The EBF acknowledges the need for coordinated regulatory involvement to determine the adequate organisational arrangements for trading platforms and investment firms in relation to issues raised by highly automated trading. The majority of its members question, however, the timing of ESMA's intervention and hope, therefore, that the high level nature of the proposed guidelines will reduce the likelihood of significant new requirements arising in relation to the points covered in the draft guidelines, following the MiFID and MAD reviews. The EBF urges ESMA to coordinate closely with the European Commission to limit the need for further such modification.**
- 2. The Federation notes that the draft guidelines will set out significant compliance and operational costs for many firms where existing policies, procedures, trading systems and controls do not meet all aspects of the guidelines. The EBF highlights the need to provide the industry with a reasonable timescale to carry out the necessary revision and implement the requirements in full.**
- 3. Furthermore, the EBF is concerned with the practical implementation of some of the proposed guidelines. For example, investment firms operating electronic trading systems cannot be asked to check whether their clients are in a position to complete the transaction.**

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EBF's interest and approach

Banks participate in financial markets for three main reasons: (i) to assist their clients in raising financial capital, transact foreign currency exchange and manage their financial risk; (ii) to serve investors who trade financial instruments and (iii) to trade financial instruments, with their own money (i.e. proprietary trading).

As the trading in financial instruments has come to rely increasingly on the use of electronic trading systems, European banks are interested in ensuring that the emerging automated trading environment remains conducive to investors' satisfaction. For that purpose, European banks wish to be constructively engaged in the debate over how to address any identified challenges to investor protection, the maintenance of fair and orderly trading conditions, market integrity and financial stability.

The guidelines presented by ESMA apply to credit institutions in two ways:

- Banks executing orders on behalf of clients or dealing on own account; and/or
- Banks operating an MTF.

As most European banks are **members/participants or users of regulated markets and MTFs** and only a small number of European banks are operating MTFs, the EBF has prepared its response (mainly) from the perspective of the former.

General Remarks

The EBF would like to share the below general remarks:

1. Although no conclusive evidence has currently been provided that demonstrates that HFT is detrimental to the market, possible market abusive behaviour in connection to the use of HFT is, nonetheless, an area of concern. Therefore, as a matter of principle, the EBF supports robust systems and controls and organizational requirements to prevent market manipulation for highly automated trading environments both within the EU and internationally, given the significant technological advances and changes in market practice that have taken place, and acknowledge the need for regulatory focus in this area.
2. The EBF acknowledges the need for coordinated regulatory involvement in this area and understands ESMA's approach in setting out high level guidelines. Furthermore, the EBF believes that the draft guidelines are pitched at broadly the right level, particularly to facilitate flexible and proportionate application.
3. The EBF notes that the draft guidelines will set out significant compliance and operational costs for many firms where existing policies, procedures, trading systems and controls do not meet all aspects of the guidelines. The EBF highlights the need to provide the industry with a reasonable timescale to carry out the necessary revision and implement the requirements in full. The EBF would also highlight the need for record keeping rules to be consistent to ensure clarity for systems' designers and to ensure a level playing field in implementation.

Generally, the eventual record keeping framework should seek to avoid firms and trading venues maintaining duplicative records.

Any rules (or clarification of existing rules by means of guidelines) aiming at better organising an automated traded environment should be flexible, dynamic, reflective of best practice and not over-detailed, to allow the reference frame to quickly adapt to changing market conditions and be designed with the overriding objective of protecting the investor, preventing market abuse and ensuring the stability and integrity of financial markets, whilst avoiding hindering technological progress or unduly restricting competition.

Responses to questions

Q.1 Do you agree with ESMA that it is appropriate to introduce guidelines already before the review of MiFID covering organisational arrangements for trading platforms and investment firms in relation to highly automated trading, including the provision of DMA/SA?

The majority of members of the EBF believe that it is not appropriate for ESMA to introduce guidelines before the review of MiFID for the following reasons:

1. Timing of the guidelines. As ESMA itself recognizes in its paper, the upcoming MiFID Review will make proposals in relation to a highly automated trading environment for trading platforms and investment firms. The MiFID Review, therefore, will overlap with ESMA's guidelines drafting process. This may lead to unnecessary market confusion.
2. Implementation costs. If ESMA's guidelines are adopted in their envisaged timeframe, market participants would be asked to implement them on a "comply or explain" basis pursuant Article 16(3) para 4 of the ESMA Regulation. It should be noted the discussed draft guidelines address organisational requirements. Implementing changes in any organisation is, by definition, a process that requires time, effort and capital spending. If the MiFID framework is shortly thereafter amended in a way that is not consistent with the guidelines, market participants would be requested to incur in unnecessary, non-proportionate costs.
3. Legislative technique. Whilst it is true that investment firms are concerned that issues raised by automated trading and direct market access (DMA) and sponsored access (SA) are being addressed in a non-harmonised way, firms consider that regulatory and supervisory consistency is best achieved through specific, targeted changes to the legal framework and note that announced, upcoming changes to the MiFID will provide an opportunity to do so.
4. Unresolved issues around ESMA's guidelines. In a separate communication to ESMA (see our letter from 11 July 2011), the EBF has highlighted some practical difficulties with the implementation of the "comply or explain" mandate. In that letter, the EBF has

called for the clarification of a number of issues that currently remain unresolved¹, making compliance challenging.

Other members of the EBF believe that there is a need for these ESMA guidelines before the MiFID review as they consider that it will take time before the MiFID review is implemented. These members stress that ESMA should coordinate closely with the European Commission to ensure any changes required to these guidelines, following the MiFID and MAD review are kept to a strict minimum.

All EBF members stress it is critical that the industry is provided with a realistic transitional period to implement the requirements, given the potential technical and operational modifications that may be necessary.

Draft guidelines on organisational requirements for regulated markets' and multilateral trading facilities' electronic trading systems

Q. 2 Do you think that the draft guidelines adequately capture all the relevant points relating to the operation of trading platforms' electronic trading systems?

Yes. The Federation supports robust organisational requirements across all trading venues, whether they are Regulated Markets (RMs) or MTFs, and support appropriately calibrated standards for harmonization of controls at trading venue level.

Q. 3 Are there areas where it would be helpful to have more detail on the organizational requirements applying to trading platforms' electronic trading systems?

No.

Q. 4 Do you have additional comments on the draft guidelines on organizational requirements for trading platforms' electronic trading systems?

The Federation believes that Guideline 1 adequately captures the key requirements in relation to operating an electronic trading system and provides useful clarification regarding aspects of MiFID.

Draft guidelines on organisational requirements for investment firms' electronic trading systems (including trading algorithms)

¹ For example: To whom and when will financial institutions need to report their compliance? To ESMA or to the national competent authority? Are there any requirements as regards the reporting format? How will financial institutions know that guidelines and recommendations are addressed to them? Will they be addressed individually? Via ESMA or via national authorities? Will there be a translation into national language(s)? Will the ESAs establish a register (similar to EUR-Lex) from which all guidelines and recommendations can easily be retrieved?

Q.5 Do you think that the draft guidelines adequately capture all the relevant points related to the operation of trading algorithms?

Yes. The EBF believes these requirements cover the key points relating to an investment firm operating an electronic trading system and provide some useful clarifications.

Q.6 Are there areas where it would be helpful to have more detail in the guidelines applying to the organisational requirements for investment firms' electronic trading systems?

Yes. The EBF would request further clarification regarding what comprises 'adequate records', e.g. retention timeframes etc., to ensure consistent interpretation of the guidelines across Member States and between firms.

Q.7 Do you have additional comments on the draft guidelines relating to organizational requirements for investment firms' electronic trading systems?

Yes. The EBF notes that ESMA is proposing guidelines for investment firms' electronic trading systems that are broadly similar to those proposed for RMs and MTFs. There are, however, some aspects in the proposed guidance that only concern investment firms. In particular:

- Investments firms' electronic trading systems (but not RMs or MTFs) would be required to monitor "on an ongoing basis" their message flow.
- under which circumstances investment firms would be required to adjust or "immediately" shut down their electronic trading system in an orderly manner, noting that RMs and MTFs are not required to shut down their system 'immediately'.

The EBF would ask ESMA to clarify why such differences have been drawn between market operators' and investment firms' respective potential obligations.

In connection to testing, the EBF concurs with ESMA that testing may be limited. Particularly, real trading cannot be fully replicated within a test environment and therefore firms need to be cautious when putting algorithms into production.

With respect to ESMA's proposal that investment firms monitor as close to real time as possible, we would note this will result in significant commitment, monitoring technology and personnel viewing on a pre-trade basis, which will have its own limitations.

Draft guidelines on organisational requirements for trading platforms to promote fair and orderly markets in a highly automated trading environment

Q.8 Do the draft guidelines on organisational requirements for trading platforms to promote fair and orderly trading offer a sufficiently comprehensive list of the necessary controls on order entry?

Yes. In particular, the EBF supports the introduction of circuit breakers, volatility controls and/or limit up/limit down processes to deal with situations when prices move an established percentage over a given limited timeframe. Given the level of controls employed by trading venues is currently uneven, the EBF welcomes this guideline in facilitating a greater degree of consistency.

Q.9 Are there any areas of the draft guidelines on organisational requirements for trading platforms to promote fair and orderly trading where you believe it would be helpful to have more detail?

No.

Q.10 Do you have additional comments on the draft guidelines on organisational requirements for trading platforms to promote fair and orderly trading?

Yes. The EBF sees opportunity for more consistency through sharing of best practices which could be facilitated at an EU level by ESMA. The EBF is aware of the existence of controls at certain exchanges which could usefully be taken up more broadly².

Draft guidelines on organisational requirements for investment firms to promote fair and orderly markets in a highly automated trading environment

Q.11 Do the draft guidelines on organisational requirements for investment firms to promote fair and orderly trading offer a sufficiently comprehensive list of the necessary controls on order entry?

The EBF agrees the guidelines are sufficiently comprehensive and recognises the importance of ensuring adequate oversight of a firm's order information. However, with regard to guideline 4.3 the EBF would suggest that in terms of over-riding pre-trade controls, it should be sufficient for approval to be granted by risk management or compliance staff, not necessarily both. The EBF also queries whether other control/risk management staff would not be better placed to review orders in as close to real time as possible, rather than compliance staff (as proposed under guideline 4.5), although we would anticipate the need for compliance to review the activity as part of a broader surveillance role. In recognition of the importance of matching the risks with the appropriate skill-sets, the EBF suggests that these provisions be redrafted and would also highlight that close-to-real-time monitoring of a firm's orders often lies principally with the Market Surveillance unit.

Furthermore, the EBF is concerned that some of the requirements may place unworkable obligations on intermediaries. For example, ESMA's draft guideline 4.2 states that "*investment firms' electronic trading systems should have to automatically block or cancel orders... if the*

² For example, Liffe has a transaction ratio of approximately 25 transactions per fill. Where this ratio is exceeded, the exchange notifies the client so they can address the issue. The client will be fined for repeated offences. Eurex has introduced a three tier system for Non Clearing Members: (1) warnings issued when near limit, (2) throttling to slow down orders and (3) hard limits which halt trading.

client does not have adequate funds or holdings of, or access to, the relevant financial instrument to complete the transaction". ESMA's wording cannot be interpreted as intermediaries having to check their client's orders re short selling.

Q. 12 Are there any areas of the draft guidelines on organisational requirements for investment firms to promote fair and orderly trading where you believe it would be helpful to have more detail?

No. the EBF believes the guidelines are sufficiently detailed but that it may be appropriate to make certain modifications, as noted above in our response to question 11.

Q. 13 Do you have additional comments on the draft guidelines on organisational requirements for investment firms to promote fair and orderly trading?

As noted above, the EBF highlights the need to clarify what is meant by 'adequate records'.

As a side consideration, the EBF would like to underline that the discussion around HFT often focuses unduly on the US flash crash. In the EBF's view, the flash crash was triggered by an ill-design selling algorithm, in combination with circumstances specific to the interlinked market structures in the US. Whilst the EBF considers that there are important lessons to learn from the flash-crash episode, extrapolation of remedies to the European context would need to take stock of existing preventive mechanisms in place in Europe, for example market-blind volatility stops.

Draft guidelines on organisational requirements for regulated markets and MTFs to prevent market abuse (in particular market manipulation) in a highly automated trading environment

Q. 14 Are there any areas of the draft guidelines on organisational requirements for trading platforms to promote fair and orderly trading where you believe it would be helpful to have more detail?

No. The EBF agrees with ESMA's view that automated trading presents additional challenges in terms of the detection of market abuse. The EBF considers, therefore, it is appropriate for trading venues to have processes in place as outlined in this guideline, as they have a view of all trading undertaken on their venue. Harmonised standards across all trading venues will also limit the opportunity for regulatory arbitrage.

Q. 15 Do you have additional comments on the draft guidelines on organisational requirements for trading platforms to promote fair and orderly trading?

The EBF would like to highlight the critical role for regulators in detecting market abuse as they are unique in having a complete view of the activity across all venues.

Guideline 5, Explanatory Notes, No. 38

It should be noted that HFT is not a single strategy but rather a set of technological arrangements. Many strategies involving HFT are not new to the markets. Strategies which constitute or seek to profit from market abuse, such as momentum ignition, layering and spoofing, should be prohibited regardless of whether it is committed through high speed trading or not.

Draft guidelines on organisational requirements for investment firms to prevent market abuse (in particular market manipulation) in a highly automated trading environment

Q. 16 Are there any areas of the draft guidelines on organisational requirements to deal with market manipulation for investment firms where you believe it would be helpful to have more detail?

The EBF agrees that firms should have arrangements in place to prevent, detect and report market abuse arising from their highly automated trading activities and broadly agrees with ESMA's suggestions. The Federation notes, however, that broadening monitoring activities are likely to necessitate changes to systems, which need a reasonable timescale for implementation.

Q. 17 Do you have additional comments on the draft guidelines relating to organizational requirements to deal with market manipulation for investment firms?

Guideline 6, no. 2, 4th dash and Explanatory Notes, no. 42

Banks have long recognised that supervisory authorities themselves are best-placed to consider what investigative powers they need to effectively enforce the MAD provisions. The EBF sees benefit in regulators performing benchmarking/thematic reviews to identify industry inconsistencies and highlight best practice with regard to monitoring. Banks stand ready to work with regulators and supervisors in the best possible way to prevent and help detect market abuse.

Having said that, EBF members have not come to a common position in connection to the potential application of Suspicious Transaction Report (STR) to orders.

- Some EBF members consider that ESMA's guidelines serve the purpose of clarifying the application of existing law (i.e. not future law). In this regard, the potential application of Suspicious Transaction Report (STR) to orders would represent an "ultra vires" interpretation of the existing legal framework and, consequently, should be resisted from a legal standpoint. Furthermore, it should be born in mind that, as intermediaries, banks only have a partial view of the markets and often, of their clients' activities, especially where clients are intent on committing market abuse and are thus more likely to use multiple brokers. Therefore, up until the legal regime is formally amended, STR should be restricted to transactions.
- Other EBF members, however, support ESMA's proposal to include the requirement to make STRs on orders to trade in these guidelines, given (1) the need for robust systems and controls to prevent market manipulation, (2) the likelihood of this provision being included in the revised MAD and (3) their expectation that ESMA limit to the extent

possible, the likelihood of significant new requirements arising and necessitating further amendment to these guidelines, following the MiFID and MAD reviews.

Draft guidelines on organisational requirements for RMs and MTFs whose members/participants and users provide direct market access/sponsored access

Q. 18 Do the draft guidelines on organisational requirements for trading platforms whose members/participants or users offer DMA/SA deal adequately with the differences between DMA and SA?

Guideline 7, no.2, 6th dash and Explanatory Notes, no. 53

Whilst the EBF agrees that trading platforms should be able to stop orders entered by way of sponsored access (SA), the EBF would suggest that it is the task of the investment firm to ask the trading platform to do so. The investment firm is responsible for all orders entered under its ID so it should be the firm that should act. Furthermore, it is the investment firm that has a contract with the sponsored client, (i.e. there is no direct/bilateral agreement between the sponsored client and the trading platform). The EBF suggests that those paras are deleted.

Q. 19 Are there any areas of the draft guidelines on organisational requirements for trading platforms whose members/participants or users offer DMA/SA where you believe it would be helpful to have more detail?

Guideline 7, no. 2, 1st dash

ESMA clarifies that trading facilities' rules and procedures should make clear that participants are responsible for orders entered under their codes. In order to ensure a strict appliance of trading rules, the EBF would like to raise awareness over a solution that is applied in certain Member States: that participants' responsibility (and the connected possible sanctions) is likewise extended to the investment firms' clients. Potential enforcement issues (e.g. how to extend sanctions in the absence of a bilateral agreement between the client and the trading platform) could be addressed by making sure that trading platforms' rules prescribe that it is the investment firms' obligation to sanction their clients if they breach such rules.

Q. 20 Do you have additional comments on the draft guidelines relating to organizational requirements for trading platforms whose members/participants or users provide DMA/SA?

No.

Draft guidelines on organisational requirements for investment firms that provide direct market access and/or sponsored access

The EBF agrees with ESMA that firms who provide direct market access and /or sponsored access to clients should have in place robust risk controls and filters to detect errors or attempts to misuse their facilities.

Q.21 Do the draft guidelines on organisational requirements for investment firms providing DMA/SA deal adequately with the differences between DMA and SA?

No. The EBF does not believe that these draft guidelines differentiate sufficiently between DMA and SA. The risk profiles associated with these types of access are different for both firms and the broader market; consequently, the systems and controls around SA should be commensurate with the potential high risk this activity presents.

Q.22 Are there any areas of the draft guidelines on organisational requirements for investment firms providing DMA/SA where you believe it would be helpful to have more detail?

The EBF believes that the requirement imposed on investment firms which offer DMA and SA under Guideline 8, no. 2, 2nd dash is unclear and requests ESMA to either redraft to clarify the meaning or to delete it.

Q.23 Do you believe that there is sufficient consistency between the draft guidelines on organisational requirements for investment firms providing DMA/SA and the SEC's Rule 15c3-5 to provide an effective framework for tackling relevant risks in cross-border activity and without imposing excessive costs on groups active in both the EEA and the US?

Yes. SEC Rule 15c3-5 targets broker-dealers with direct trading or “market” access to an exchange or alternative trading system (“ATS”), or that provide a customer or any other person with access to an exchange or ATS through use of its market participant identifier or otherwise. These firms will be required to establish, document, and maintain a system of risk management controls and supervisory procedures reasonably designed to manage the financial, regulatory, and other risks of its market access business. The rule applies to transactions by all broker-dealers with market access. These requirements are broadly similar to the ones being prescribed in the EU context.

Q.24 Do you have additional comments on the draft guidelines on organizational requirements for investment firms providing DMA/SA?

Guideline 8, no. 2, 5th dash

Consistent with our response to question 11 , the EBF opposes pre-trade controls on the orders of direct market access/sponsored access clients that amount to the blocking or cancelling of orders where those clients do not have the adequate funds or holdings of, or access to, the relevant financial instruments to complete the transactions. The implementation of this guideline may place unworkable obligations on intermediaries. ESMA’s wording cannot be interpreted as intermediaries having to check their client’s orders re short selling.

Guideline 8, no 2, 7th dash

The EBF does not think that it makes sense that investment firms receive all order entries real-time. Nor is it necessary, since it is the task of Market Surveillance to screen the market.

General question regarding the draft guidelines in Annex VII

Q. 25 Does the explanatory text provided in addition to the guidelines (see Annex VII to this CP) help market participants to better understand the purpose and meaning of the guidelines? Should it therefore be retained in the final set of guidelines?

The EBF finds the explanatory text useful. It should be retained in the final set of guidelines as long as it is clarified that it does not fall under the “comply or explain” obligation pursuant Article 16(3) of the ESMA Regulation.