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German High Frequency Trading Act Potential implications for HFT firms and other firms using automated trading strategies

On 30 July 2012, the German Ministry of Finance published a discussion draft bill regarding High Frequency Trading for the German financial services sector in the form of an "Act for the Prevention of Risks and the Abuse of High Frequency Trading" ("HFTA"). The new rules amend various German laws to extend their application to high frequency and algorithmic trading. HFTA is expected to be finalised and in force in Germany as early as March 2013. The effects of the proposed HFTA are far-reaching and are likely to affect not only HFT firms based in Germany, across Europe and elsewhere (if they are members of an organised market, e.g. Xetra or Eurex, or multilateral trading facility ("MTF") in Germany) but also any trading firm (including market makers) which uses algorithmic trading strategies for trading on its own account.

Definitions of Algorithmic trading

The HFTA proposals introduce new definitions of 'algorithmic trading' and 'algorithmic high-frequency-trading' into German financial services legislation where they have not existed before. Firms falling within the 'algorithmic high-frequency-trading' definition will become subject to German regulatory authorisation and supervision. Organisational and technical requirements apply to firms falling within both these definitions. A summary of the proposed requirements is set out below.

New License requirement

The proposed legislation targets the specific risks in connection with computer based algorithmic high frequency trading ("HFT") at German trading venues and will, for the first time, (owing to the extended definition of proprietary trading), trigger a German banking license requirement for both German and other European HFT firms trading financial instruments for their own account by means of an algorithmic high-frequency trading strategy.

Additional Resources

Additional resources and newsletters are available at www.orrick.com.

Contact a Team Member

Please contact one of the following team members or your usual Orrick contact if you would like to discuss any of the points raised in this alert.

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Supervision

In addition, the proposed legislation provides increased supervisory powers for the relevant German stock exchange supervisory authority.

The HFTA provides that the supervisory authority will have the power to request detailed information from trading participants carrying out algorithmic trading including (1) information on their algorithmic trading, (2) information on their trading systems, (3) a description of the algorithmic strategies and (4) details regarding trading parameters and trading limits of the system. If the stock exchange supervisory authority considers that a certain strategy poses a risk to the financial system in Germany it is proposed that it will have the power to prohibit an algorithmic trading strategy. It is proposed that all algorithmic traders will fall within the supervision of the German supervisory authority (BaFin) which may, in addition to the local supervisory authorities, additionally demand information on procedures for risk management, compliance and system checks.

Technical requirements

The HFTA draft proposes new technical obligations and limitations:

1. Requiring exchanges to apply an appropriate ratio between bid/ask orders entered and orders executed. This ratio shall be set individually for each financial instrument taking into account their trading volumes over a monthly period. This provision appears to have been adopted in advance by the Frankfurt Stock Exchange which from March 2012 demands increased fees from members of the exchange if they have an overly high order to trade ratio.

2. Provide for an adequate minimum tick size for all traded financial instruments on exchanges and MTFs.

3. Exchanges and MTFs will also be required to take adequate measures to ensure that the orderly fixing of quotations is possible in the event of substantial market volatility including short term circuit breakers.

Market manipulation

The definition of the types of behaviour constituting market manipulation will be extended to include bid/ask orders transmitted to the market by a computer algorithm, if intended to disturb or delay the functioning of trading systems or create a misleading impression.

Organisational duties

All algorithmic traders will be required to have in place risk management procedures in an effort to ensure that trading systems are stable, have sufficient capacity and appropriate trading thresholds and limits.

Algorithmic traders will be required to maintain emergency provisions for dealing with unforeseen disturbances in their trading systems. These regulatory requirements are similar to the MiFID II proposal, expected to be implemented in 2015.

Timing

The German Minister of Finance, Wolfgang Schäuble, announced on 3 September 2012 that the government draft bill which initiates the legislation process will be published by October 2012. This means that the HFTA is likely to be in final legislative form by the end of December 2012 with full implementation by March 2013. The draft proposals suggest that the HFTA will allow a 3 month period for license applications to be granted following implementation of the HFTA provided that a complete license application is lodged by the implementation date (March 2013).

Key outstanding questions

There is currently no certainty about whether the draft legislation is intended to apply to non-German firms which are already authorised and regulated by an EU competent authority and firms accessing trading venues through 'sponsored access' arrangements. However, it appears unlikely that regulated firms passporting into Germany will require further authorisation.

The position with regard to UK regulated firms (e.g. locals) operating without a passport is unclear.

It is currently unclear whether the scope of the German HFT definition will cover market making or other forms of electronic trading.

Actions for firms now

Firms potentially covered by the new legislation will be watching developments with great interest. Firms that are currently unregulated may be giving careful thought to preparing themselves for authorisation and regulatory supervision and considering the jurisdiction (s) in which they may be supervised. Lead times mean firms wishing to opt for UK authorisation may need to act now.