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MiFID II – Trading Venues And High Frequency Trading

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This is the third part in a series of Legal Longs on the MiFID II Directive [2014/65/EU] and the Markets in Financial Instruments Regulation (MiFIR) (together, "MiFID II"), which will come into effect on 3 January 2017. This third part provides a brief summary of the new trading venues introduced by MiFID II and the key changes to existing trading venues, and clarification of algorithmic and high frequency trading.

Trading venues

There are three types of trading venues recognised under MiFID, namely: (i) regulated markets (RMs); (ii) multilateral trading facilities (MTFs); and (iii) systematic internalisers (SIs). MiFID II will introduce an additional venue, the organised trading facility (OTF), which is intended to capture broker dealing systems and inter-broker dealing systems, which currently operate outside of the MiFID requirements, and introduces the new concept of SME growth markets.

Organised Trading Facilities (OTFs)

An OTF is defined very broadly as a "multilateral system which is not a regulated market or an MTF and in which multiple third party buying and selling interests in bonds, structured finance products, emission allowances or derivatives are able to interact in the system in a way that results in a contract". One aim is to regulate so-called 'dark pool' trading i.e. private trading platforms which are not subject to pre-trade transparency. OTFs will be subject to many of the rules which apply to RMs and MTFs, including pre-trade transparency and the requirement not to execute orders against proprietary capital. However, whereas RMs and MTFs are only permitted to execute orders on a non-discretionary basis, OTFs will have discretion as to how an order is executed. Generally, dark pools currently carry out some proprietary trading, such as offsetting unmatched trades, but once designated as an OTF, no proprietary trading will be permitted. SIs are, however, permitted to undertake proprietary trading, and this appears to be the key distinction between OTFs and SIs.

SME growth markets

MiFID II will also introduce a new concept, that of small and medium-sized enterprise (SME) growth markets. Currently, SME growth markets are usually operated under MiFID as MTFs, such as AIM in the UK, which is an MTF and not a regulated market under MiFID. MiFID II envisages that the creation within the MTF category of a new sub-category of SME growth market and the registration of those markets will facilitate access to capital for SMEs and the further development of specialist markets that aim to cater for the needs of smaller and medium-sized issuers by lessening the administrative burdens and creating further incentives for SMEs to access capital markets through SME growth markets.

Systematic internalisers (SIs)

The MiFID definition of an SI applies to a firm which is trading equities in an organised, frequent and systematic way above a defined standard market size. A firm which is an SI has to provide pre-trade transparency and in some respects it could be said to operate as a quasi-market maker. MiFID II has altered this definition so that trading now has to be undertaken on a 'substantial' basis. The products subject to the SI regime will also be extended from equities to bonds, derivatives, structured finance products and emissions allowances. Also, SIs will be required to bid a minimum quote size and to place both bid and offer prices (rather than one-way prices).

ESMA has given more guidance on what "frequent", "systematic", and "substantial" mean in the context of the SI definition and has proposed the following thresholds:

1. for trading in equities, the threshold for 'frequent and systematic' is 0.4% of EU trading in a liquid instrument;
2. as regards 'substantial', if the firm's trading activity in a financial instrument is equal to or larger than either: (a) between 15% and 25% of the total turnover in that financial instrument executed by the investment firm on own account or on behalf of clients; or (b) 0.4% of the total turnover in that financial instrument in the EU, it will be deemed to be undertaken on a "substantial basis";
3. a similar approach will be taken for non-equity markets, although the percentages will be slightly different; and
4. a share will be liquid if it has a free float of above €100 million, and either of the following two tests is met: (x) the average daily number of transactions is more than 250; or (y) the value of the average daily transactions is more than €1 million.

ESMA will calculate the various thresholds on a rolling six-month basis and after triggering a requirement firms will then have two months to comply with the SI pre-trade transparency regime.

High frequency algorithmic trading

Regulators have become increasingly concerned about the change in trading patterns caused by high frequency algorithmic trading (HFT), which is algorithmic trading characterised by an attempt to minimise speed, including possible systemic risks posed by this type of trading, and MiFID II introduces new rules in response to this concern. Under MiFID II, an entity undertaking HFT is required to become authorised as an investment firm and to comply with compulsory market-making rules i.e. traders are unable to suspend trading but are required to be in continuous operation during the trading hours of the trading venue to which they send orders. The firm must post firm quotes in relation to the relevant strategy at competitive prices on a regular and ongoing basis, regardless of market conditions, thereby requiring such traders to act as market makers. The potential impact of this latter requirement has been the cause of most concern to algorithmic traders. HFT traders must be properly supervised and will be required to put in place effective systems and risk controls to ensure that trading systems are resilient and have sufficient capacity, are subject to appropriate trading thresholds and limits and prevent the sending of erroneous orders. Finally, they will be expected to provide their regulator with an annual description of their trading strategy, details of risk parameters and key compliance and risk controls.

MiFID II provides two different definitions for the concepts of 'algorithmic trading' and 'high frequency algorithmic trading technique' and states that HFT is a specific sub-set of algorithmic trading. As it is only a person applying HFT trading which is required to be authorised as an investment firm, it is necessary to distinguish between the two concepts of algorithmic trading and HFT to ensure the uniform application of the authorisation requirement. MiFID II has defined each of the concepts as follows:

- algorithmic trading – this 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. This 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; and
- HFT – this is defined as an algorithmic trading technique characterised by: (a) 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; (b) system-determination of order initiation, generation, routing or execution without human intervention for individual trades or orders;

and (c) high message intraday rates which constitute orders, quotes or cancellations.

ESMA is required to provide guidance on these definitions and has provided the following clarification in its final report [ESMA/2014/1569] on this issue. As regards algorithmic trading, ESMA considers that: (i) automated trading decisions and the optimisation of order execution processes by automated means are included in the definition of algorithmic trading; (ii) arrangements are considered as algorithmic trading if the system makes independent decisions at any stage of the processes on either initiating, generating, routing or executing orders (and 'orders' encompasses quotes as well); and (iii) automated order routers that only determine the venue(s) where the order should be submitted without changing any other parameters of the order are excluded, which means that smart order routing systems may be captured. As regards clarification of the HFT definition, ESMA has advised the European Commission to follow one of the following three options for the identification of 'high message intra-day rates' within the HFT definition:

1. absolute threshold per instrument is above 2 messages per second; or
2. absolute threshold per trading venue and per instrument of at least 4 messages per second per venue or 2 messages per second with respect to any single instrument; or
3. relative threshold between the 20th and the 40th percentiles of the daily lifetime of modified or cancelled orders from all members or participants on a trading venue.

Further, ESMA has stated that only proprietary order flow should be considered and thus an investment firm may challenge its classification as HFT if the firm believes that this classification is a direct result of their non-proprietary messaging flow.

With regard to the compulsory market-making requirement referred to above, in its final report ESMA has clarified that this will only apply where it is the investment firm, and not its client, that is undertaking the HFT business. As a result, few investment firms should be hit by this requirement, but some of their clients may be.

Requirement to report abusive behaviour

MiFID II imposes new requirements on trading venues to ensure that they have systems in place to prevent market disruption caused by algorithmic trading or market stress generally. Further, trading venues are required to immediately inform their competent authorities (NCAs) of significant infringements of their rules or disorderly trading conditions or conduct that may indicate abusive behaviour or system disruptions in relation to a financial instrument within the meaning of the Market Abuse Regulation (MAR). ESMA has proposed an indicative and non-exhaustive list of signals of market abuse behaviour and stated that trading venues should apply a proportionate approach in determining whether such behaviour triggers the signals before deciding to inform the relevant NCA(s). The signals of potential insider dealing or market manipulation are set out in the Annex to Chapter 6 of ESMA's final report.

Communications between trading venues

One final point is that MiFID II contains new rules requiring a trading venue, in the event that it suspends or removes a financial instrument from trading, to make this public and to communicate it to other trading venues. Other trading venues will then be required to take the same action where the suspension or removal is due to the non-disclosure of information about the issuer or financial instrument.

In our final Legal Long in this series, we shall be looking in more detail at reporting and transparency rules under MiFID II and the rules applying to third country firms.

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