Financial Conduct Authority

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Breakout session: Microstructural issues

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Agenda

- Background
- RTS 6 Organisational requirements: investment firms
- RTS 7 Organisational requirements: trading venues
- RTS 8 Market making
- RTS 9 Order-to-Trade Ratio (OTR)
- RTS 10 Fee structures and co-location
- RTS 11 Tick sizes
- RTS 12 Material markets in terms of liquidity
- Next steps

Background

Level 1

- MiFID II imposes stricter requirements for investment firms (IFs) engaged in algorithmic trading or pursuing a high frequency trading strategy. Articles 17/48 look to build on the ESMA guidelines on systems and controls in an automated trading environment.
- In light of past market events, new regulation to harmonise tick sizes used in the trading venues (TVs) and formalise market making arrangements to enhance stability of the market.

Regulatory Technical Standards

- RTSs 6-12 provide a set of requirements for those IFs engaged in algorithmic trading and for TVs that accommodate them.

Organisational requirements: investment firms

Formalises the 2012 ESMA Guidelines but with new requirements:

- Mandatory requirement for the prior testing of algorithms in a test environment provided by the TVs an IF wishes to access (for conformance testing) or by a third party. Separation of testing environment and production environment;
- Continuous self-assessment and stress testing of the trading systems;
- Outsourcing and procurements;
- Order recording formats for HFTs; and
- Independent systems and controls requirement for Direct Electronic Access (DEA) providers. DEA providers must vet and take responsibility for all their clients' activities. Due diligence requirement on DEA provision. TVs must outline a framework for IFs to adhere to when providing DEA.

Organisational requirements: trading venues

Formalises the 2012 ESMA Guidelines but with new requirements:

- Requires TVs to provide an environment for IFs to perform conformance testing and testing for disorderly trading conditions. TVs must require IFs to undertake these algo testing prior to the deployment of an algorithm (but not required to certify the algos);
- Infrastructure of the TV must cope with twice their historical peak message volume (highest number of messages per second) in the past 5 years;
- Continuous self-assessment and stress testing of the trading systems;
- Prescriptive measures on the prevention of disorderly trading conditions; and
- DEA – TVs must specify the IF's minimum requirements in providing DEA, and sponsored access clients must be authorised by the TV.

Market making

- Market making obligations for algorithmic traders are construed independently from other legislations;
- Article 17/48 market making obligation is intended to encourage the presence of liquidity providers in stressed market conditions, rather than during normal market conditions, where each TV may decide what fits best to its own business model;
- Applicable only to members and participants of the TVs;
- RTS requires a market making agreement to be signed with the relevant TV when posting firm, simultaneous two-way quotes of comparable size and competitive prices when dealing on their own account in at least one financial instrument on one TV; and
- The terms of the agreement is left up to the IFs and the TV to determine.

Market making (cont.)

- An agreement to be concluded with the TV if present in the market for at least 50% of the daily trading hours for half of the trading days over a one month period;
- Once signed, must be present in the market for 50% of the continuous trading hours, for each trading day posting simultaneous two-way quotes on that TV except during exceptional circumstances;
- TVs must have a market making scheme only for equities and equity-related instruments that are traded on an automated, continuous auction order book system;
- TVs must set out the incentives, parameters to be met in terms of presence time, size and spread as minimum criteria, and the parameters identifying stressed market conditions; and
- Access to market making schemes must be fair and non-discriminatory.

Order to trade ratios (OTRs)

- A uniform methodology for calculating OTRs across EU venues;
- Where used, a daily calculation should be undertaken for each member / participant, using the following formula:

$$\text{(a)}\ \frac{Total\,Volume\,of\,Orders}{Total\,Volume\,of\,Transactions} - 1$$

$$\text{(b)}\ \frac{Total\,Number\,of\,Orders}{Total\,Number\,of\,Transactions} - 1$$

- The venue sets the maximum ratio of unexecuted orders to trades. OTR deemed to have been exceeded if during a trading session, the trading activity of the member / participant in one specific instrument exceeds the limits set by the TV on either of the above formula.

Fee structures and co-location

- Fees should be fair, transparent and non-discriminatory;
- Prohibits fee structures that encourages IFs to trade in a disruptive manner; and
- Co-location services must be provided in a fair, transparent and non-discriminatory manner.

Tick size

- A new harmonised pan-EU tick size regime to prevent the use of tick size as a competition tool. Establishes minimum tick size taking into consideration price, liquidity and the spread;
- All equities, equity-only ETFs and depositary receipts will be placed into one of the 6 liquidity bands, calculated annually based on the average daily number of trades on the TV determined as the most relevant market in terms of liquidity. Higher the number of trades, the smaller the tick sizes;
- Relevant NCAs to apply a new liquidity band and treat an instrument as if it were first admitted to trading where a corporate action may materially modify the average daily number of trades; and
- To apply the RTS from 3 January 2017, transitional provisions mandate TVs to collect and calculate the average daily number of trades by 1 December 2016. The calculation will be based on the available data for the period 1 January 2016 to 30 September 2016.

Tick size (cont.)

Price ranges	Liquidity bands					
	0 ≤ ADNT < 10	10 ≤ ADNT < 80	80 ≤ ADNT < 600	600 ≤ ADNT < 2,000	2,000 ≤ ADNT < 9,000	9,000 ≤ ADNT
0 ≤ P < 0.1	0.0005	0.0002	0.0001	0.0001	0.0001	0.0001
0.1 ≤ P < 0.2	0.001	0.0005	0.0002	0.0001	0.0001	0.0001
0.2 ≤ P < 0.5	0.002	0.001	0.0005	0.0002	0.0001	0.0001
0.5 ≤ P < 1	0.005	0.002	0.001	0.0005	0.0002	0.0001
1 ≤ P < 2	0.01	0.005	0.002	0.001	0.0005	0.0002
2 ≤ P < 5	0.02	0.01	0.005	0.002	0.001	0.0005
5 ≤ P < 10	0.05	0.02	0.01	0.005	0.002	0.001
10 ≤ P < 20	0.1	0.05	0.02	0.01	0.005	0.002
20 ≤ P < 50	0.2	0.1	0.05	0.02	0.01	0.005
50 ≤ P < 100	0.5	0.2	0.1	0.05	0.02	0.01
100 ≤ P < 200	1	0.5	0.2	0.1	0.05	0.02
200 ≤ P < 500	2	1	0.5	0.2	0.1	0.05
500 ≤ P < 1000	5	2	1	0.5	0.2	0.1
1000 ≤ P < 2000	10	5	2	1	0.5	0.2
2000 ≤ P < 5000	20	10	5	2	1	0.5
5000 ≤ P < 10000	50	20	10	5	2	1
10000 ≤ P < 20000	100	50	20	10	5	2
20000 ≤ P < 50000	200	100	50	20	10	5
50000 ≤ P	500	200	100	50	20	10

Material markets in terms of liquidity

- Determines which market is material in terms of liquidity, for the purposes of MiFID II Article 48(5) trading halt notifications;
- To keep consistency in ESMA's approach, this RTS mirrors the provisions in the Transparency Chapter for equities (RTS 1 Art 4); and
- For non-equity instruments, the market where the instrument was first admitted to trading is deemed as the material market.

Next steps

Implementation of the RTS

- Timelines until implementation;
- European Commission to finalise the definitions on HFT and specification of DEA.

Future ESMA work

- Guidelines on the calibration of Article 48(5) trading halts;
- ESMA Q&As: provide further interpretation of the RTS;
- Monitoring the effective implementation of the new tick size regime (as mandated by MiFID II for ESMA to seek regular input from national experts on the developments related to trading technology [Recital (68)]); and
- Report to the European Commission on the effective implementation of the requirements regarding algorithmic trading and HFT.

Questions?

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