Bundesanstalt für
Finanzdienstleistungsaufsicht

BaFin

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Information provided by BaFin on the German High-frequency Trading Act

On 14 May 2013 the Act on the Prevention of Risks and Abuse in High-frequency Trading (High-frequency Trading Act, *Hochfrequenzhandelsgesetz*) has been promulgated. In essence the Act contains the following rules:

1) <u>Authorisation requirement for high frequency traders:</u>

High frequency traders will be subject to supervision by BaFin in the future. The authorisation requirement captures direct and indirect participants of a German organised market or MTF if they trade by means of a high frequency algorithmic trading technique which is characterised by

- the use of infrastructures intended to minimise latencies (e.g. collocation, proximity hosting)

- system determination of order initiation, generating, routing or execution without human intervention for individual trades or orders and

- a high message intraday rate in terms of orders, quotes or cancellations.

A high frequency algorithmic trading technique assumes that all of the three criteria mentioned above are fulfilled (cumulative enumeration).

In relation to infrastructures intended to minimise latencies two criteria are essential on the basis of the existing state of art and knowledge:

- the distance between the matching machine of the trading venue and the server at which the algorithms are executed and

- the amount of data, that is transferred by line per second (bandwidth).

On the basis of the existing state of art and knowledge BaFin assumes that infrastructures intended to minimise latencies are used if the server at which algorithms initiate, generate, route or execute orders is placed within direct proximity to the matching machine of the trading venue and if a bandwidth of 10 gigabit per second is used.

A system determination on order initiation, generating, routing or execution of an order requires an independent decision of the system. Such a decision is also assumed if the system reacts on algorithms or single parameters of an algorithm of other systems and in consequence initiates, generates, routes or executes orders without further human intervention.

On the basis of the existing state of art and knowledge a high message intraday rate is assumed at 75.000 messages per trading day at annual average.

The authorisation requirement will trigger, inter alia, obligations for firms in relation to risk management, capital requirement and reporting.

2) Effective systems and risk controls

If an investment services firm conducts trading in financial instruments in such a way that a computer algorithm automatically determines individual parameters of orders, unless the system involved is used only for the purpose of routing orders to one or more trading venues or for the confirmation of orders (algorithmic trading), it must have in place effective systems and risk controls in accordance with section 33 (1a) of the German Securities Trading Act (Wertpapierhandelsgesetz – WpHG) to ensure its trading systems

- are resilient, have sufficient capacity and are subject to appropriate trading thresholds and limits;

- prevent the sending of erroneous orders or the system's functioning in a way that may create or contribute to a disorderly market;

- cannot be used for any purpose that is contrary to European or national rules against market abuse or to the rules of a trading venue to which it is connected.

An investment services enterprise that conducts algorithmic trading must also have in place effective business continuity arrangements to deal with unforeseen failures of its trading systems and must ensure that its systems are fully tested and properly monitored. Furthermore, it must ensure the documentation of every modification of any computer algorithm used for trading purposes.

The obligation to have effective systems and risk controls in place also applies to asset management companies *(Kapitalanlagegesellschaften)* and self-managed investment stock corporations (*Investmentaktiengesellschaften)*.

3) Flagging obligation

Exchange rules of Securities Exchanges must include provisions on the flagging of orders generated by algorithmic trading and of the trading algorithms used therefore. Furthermore, MTF operators are obliged to define rules on the flagging of orders in the future.

4) Appropriate Order-to-trade ratio

Moreover, in the future trading participants are required to ensure an appropriate Order-to-trade ratio in order to prevent risks to the orderly exchange trading. Exchange rules will stipulate more concrete details. MTF operators must also ensure and monitor in the future that trading participants ensure an appropriate order-to-trade ratio.

5) Further rules

In addition to the requirements mentioned above, the Act contains further obligations for trading venues on charging fees for the excessive usage of exchange systems, on the determination of an appropriate minimum tick size and on taking suitable precautionary measures to ensure an orderly determination of the exchange price even when prices fluctuate significantly (in particular circuit breakers). Furthermore, the Act clarifies that trading practices involving algorithmic trading can be considered as market manipulation under certain circumstances. Finally, the Act provides supervisory authorities with the power to demand information on algorithmic trading.

6) Transition periods

With respect to the authorisation requirement, the Act stipulates transitional periods for applying for an authorisation in accordance with section 64p of the German Banking Act (Kreditwesengesetz – KWG). A transitional period of six months applies to German enterprises so that they have to submit a complete application for authorisation until 14 November 2013. A transitional period of nine months applies to enterprises that are not domiciled in Germany and that are not enterprises within the meaning of section 53b (1) sentences 1 and 2 of the KWG. These enterprises have to submit a complete application for authorisation until 14 February 2014. The obligation for trading venues to introduce regulation on the flagging of algorithmic orders in accordance with section 16 (2) No. 3 of the German Exchange Act (Börsengesetz – BörsG) and the organisational requirements in accordance with section 33 (1a) of the German Securities Trading Act (Wertpapierhandelsgesetz – WpHG) in conjunction with section 9a (1) of the German Investment Act (Investmentgesetz – InvG) will come into force on 14 November 2013.

Please note that only the German version of the High-frequency Trading Act is authentic.

BaFin strives to clarify questions in the market on the application of the Act as soon as possible. Therefore, BaFin has published first information on its website including Frequently Asked Questions (FAQs) relating to the new provisions which will be regularly updated. The information is available under the following link:

http://www.bafin.de/SharedDocs/Veroeffentlichungen/EN/Meldung/2013/meldung_130322_hft-gesetz_en.html

Questions to BaFin on the implementation of the High-frequency Trading Act can be sent to the following e-mail address: hft@bafin.de.

Furthermore, BaFin held a workshop on the High-frequency Trading Act on 30 April 2013 in Frankfurt. The presentations on this are available under the following link:

http://www.bafin.de/SharedDocs/Veranstaltungen/EN/WA11_20130430_hft_workshop_en.html