European Securities and Markets Authority

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PRESS RELEASE

ESMA outlines future automated trading regime for trading platforms, investment firms and competent authorities

ESMA today published its final report on guidelines on systems and controls in an automated trading environment for trading platforms, investment firms and competent authorities (ESMA/2011/456). In issuing these guidelines, ESMA rolls out a comprehensive regime governing the operation of electronic trading systems by a regulated market, a multilateral trading facility (MTF) or investment firms. The guidelines cover trading in an automated environment of any financial instruments, as defined in the Market in Financial Instruments Directive (MiFID).

In accordance with Article 16(3) of the ESMA Regulation, national competent authorities and financial market participants must make every effort to comply with guidelines and recommendations. The guidelines will become effective by 1 May 2012.

Steven Maijoor, ESMA Chair, *said that:*

"The publication of today's guidelines is an important step towards improving the oversight of automated trading. ESMA is committed to ensure that technological innovation does not pose a risk to the orderly functioning of the markets and will continue to monitor closely the developments in financial markets, including those which could impact on the resilience of market infrastructures. These guidelines will help contributing to the stability and robustness of European electronic trading systems, which is why ESMA implements these guidelines now without waiting for the completion of the MiFID review. In doing so, ESMA advances in establishing consistent, efficient and effective supervisory practices in this important area of European regulation".

Regulated markets and MTFs must have proper arrangements in place

Maintaining the orderly functioning of the markets is one of the aims in defining rules for algorithmic trading. ESMA's guidelines therefore indicate that regulated markets and MTFs should have arrangements in place to that end. These arrangements should include:

- adequate **pre-trade controls**, such as the possibility to limit the number of orders which each member/participant or user can send to the trading platform; and
- **conformance tests** to ensure that members/participants' or users' IT systems are compatible with the trading platforms' electronic trading systems; and
- **automatic and discretionary mechanisms** to constrain trading or to halt trading in response to significant variations in price to prevent trading becoming disorderly; and
- undertaking adequate **due diligence** of the member/participant or user before accepting their market access and the ability to check their respective controls and arrangements afterwards; and
- clear **organisational requirements** for members who are not regulated entities; and

- **rules and procedures** designed **to prevent, identify and report** instances of possible **market abuse and market manipulation** that are proportionate to the nature, size and scale of the business done through the trading platform.

Organisational requirement for investment firms

Investment firms using algorithms, according to the ESMA guidelines must also have organisational arrangements to maintain fair and orderly trading. This includes:

- an **appropriate governance** process for developing or buying algorithms, rolling out the live use of the algorithm in a cautious fashion and staff with necessary up-to-date skills and expertise to run and monitor the behaviour of their live algorithms; and
- **pre-trade controls** which address erroneous order entry and maintain pre-set risk management thresholds, including thresholds on maximum exposure to individual clients (Annex I, Guideline 4); and
- investment firms' **responsibility for** all order flow to venues from clients using **direct market access or sponsored access**, conduct adequate due diligence on clients using direct market access and sponsored access services and ability to immediately halt trading by these clients.

In addition, regulated markets, MTFs and investment firms must keep adequate records of their systems and controls covered by the guidelines to enable competent authorities to assess their compliance with MiFID and other relevant regulatory obligations (Guidelines 1, 2, 3, 4, 5 and 7).

ESMA work related to automated trading will not end with the finalisation of these guidelines, and will continue either within the current legislative framework or the context of the MiFID review.

Notes for editors

1. ESMA is an independent EU Authority that was established on 1 January 2011 according to EU Regulation No. 1095/2010 as published on December 15, 2010, in the Official Journal of the European Union (L 331/84). The Authority contributes to safeguarding the stability of the European Union's financial system by ensuring the integrity, transparency, efficiency and orderly functioning of securities markets, as well as enhancing investor protection. In particular, ESMA fosters supervisory convergence both amongst securities regulators, and across financial sectors by working closely with the other European Supervisory Authorities competent in the field of banking (EBA), and insurance and occupational pensions (EIOPA).

2. ESMA's work on securities legislation contributes to the development of a single rule book in Europe. This serves two purposes; firstly, it ensures the consistent treatment of investors across the Union, enabling an adequate level of protection of investors through effective regulation and supervision. Secondly, it promotes equal conditions of competition for financial service providers, as well as ensuring the effectiveness and cost efficiency of supervision for supervised companies. As part of its role in standard setting and reducing the scope of regulatory arbitrage, ESMA strengthens international supervisory co-operation. Where requested in European law, ESMA undertakes the supervision of certain entities with pan European reach.

3. ESMA also contributes to the financial stability of the European Union, in the short, medium and long-term, through its contribution to the work of the European Systemic Risk Board, which identifies potential risks to the financial system and provides advice to diminish possible threats to the financial stability of the Union. ESMA is also responsible for coordinating actions of securities supervisors or adopting emergency measures when a crisis situation arises.

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