



Guidelines on systems and controls in an automated trading environment for trading platforms, investment firms and competent authorities. March 2012.

On 22 December 2011, ESMA published the final report containing the guidelines on systems and controls in an automated trading environment for trading platforms, investment firms and competent authorities. These guidelines will become effective one month after the publication by national competent authorities on their official website in their national language so that market participants should be able to comply with these guidelines from 1 May 2012. ESMA guidelines are not binding and national competent authorities must notify ESMA whether they comply or intend to comply with these guidelines, with reasons for non-compliance two months after publication of the final guidelines in all EU official languages by ESMA. The document contains 8 guidelines that develop the organisational requirements for trading venues and investment firms; each guideline has a general content and a detailed one that, related to record keeping and cooperation, is repeated in all of them fitting the contents to each following headline:

Guideline 1- Electronic trading systems: trading venues.

Trading venues (Regulated Markets and Multilateral Trading Facilities by now) electronic systems should be well adapted to the business which take place through them and ensure continuity and regularity in the performance of the automated market. Its governance will take place through a clear and formalised governance process in which all commercial, technical risk and compliance considerations will be taken into account, as well as its different stages (development, sign off, initial deployment, subsequent update, resolution of problems identified through monitoring, and communication of information). They should have capacity and resilience to accommodate reasonably foreseeable volumes of messaging and to be increases in order to respond to rising message flow and emergency conditions that might threaten their proper operation; should have effective business continuity arrangements to address disruptive incidents including but not limited to system failures; should prior to deploying make use of delineated development and testing methodologies; should be subject to real time monitored and to periodic internal reviews; should assure security in case of misuse or unauthorised access; and should have procedures for staff recruitment and training.

Guideline 2- Electronic trading systems: investment firms.

This guideline has the same content as number 1 adding specific provisions for the electronic trading systems which, in case of trading algorithms, should make use of performance simulations, back testing or offline-testing with the purpose of ensuring compatibility with the investment firm's obligations and the rules of the trading platforms they use, and with the compliance and risk management controls (including generating error reports automatically and the continuity in stresses market conditions). Algorithm tests should be adapted to the strategy the firm will use the algorithm for including the markets to which it will send orders and their structure. Investment firms should roll out the deployment of trading algorithms in a live environment in a controlled and cautious fashion (for example, limiting the number of financial instruments being traded, the value and number of orders and the number of markets to which orders are sent).

Guideline 3.- Fair and orderly trading: trading venues.

Trading venues should have rules and procedures for fair and orderly trading appropriate to the nature and scale of trading, types of members, participants and users and their trading strategies. They should perform adequate due diligence on applications to become a member/participant or user from persons who are not credit institutions or investment firms, monitor the trading and performance tests to ensure that the members/participants/users systems minimum level of functionality is compatible with the trading platforms' electronic trading systems. They will have requirements for members/participants/users' pre- and post-trade controls and, in particular, on filtering

order price and quantity; they should have standards covering the knowledge of persons who will be using order entry systems and the ability to prevent the access of a member/participant/user; they should have arrangements to prevent the excessive flooding of the order book (limits per participant on order entry book) and measures to prevent capacity limits on messaging from being breached; they will have arrangements to constrain or to halt trading in individual or multiple financial instruments; and will obtain information to facilitate monitoring as close to real time as possible to detect signs of disorderly trading.

Guideline 4- Fair and orderly trading: investment firms.

Investment firms are, partly, described in guide number 3 in relation to functionality and compatibility of electronic system, personal recruitment and real time monitoring. Besides, the investment firms' policies and procedures to promote fair and orderly trading will assure the consistency of the electronic systems and the orders these generate with the rules of the trading venues to which the order are to be sent, and the ability to manage specific risks derived from electronic trading. They will have automatic block or cancel orders that: a) do not meet size or price parameters; b) are not correctly authorised; and c) compromise firms' own risk management thresholds. They will put in place internal procedures to inform competent authorities, to approve overriding pre-trade controls, in case of failures or regulatory infractions, control of messaging traffic and management of operational risk.

Guideline 5- Market abuse (manipulation) prevention: trading venues.

Trading venues should have arrangements and procedures so that specially trained staff could identify conduct by their members/participants/issuers that may involve market abuse (market manipulation) such as, potentially, the following: ping orders (small orders to ascertain the level of hidden orders and particularly used to assess what is resting on a dark platform); quote stuffing (large numbers of orders and/or cancellations/updates to create uncertainty slowing down their process and camouflaging their own strategy); momentum ignition (orders or series of orders to start or exacerbate a trend and encourage other participants to accelerate it and create an opportunity to open a position at a favourable price; and layering and spoofing (multiple orders often away from the touch on one side of the order book with the intention of executing a trade on the other side of the order book and, once that trade has taken place, the manipulative order will be removed). They will have automated alert systems on transactions and orders with capacity to accommodate high frequency generation of orders and transactions with the aim of tracing back transactions and orders entered/cancelled which may involve market manipulation; and will have arrangements for the identification of suspicious transactions and orders and its reporting without delay to the competent authority. All procedures and arrangements are subject to periodic reviews and internal audits.

Guideline 6- Market abuse (manipulation) prevention: investment firms.

Investment firms should have specifically trained staff to minimise the risk that their automated trading activity gives rise to market abuse (in particular market manipulation). Guideline 5 will be applicable related to suspicious transactions, periodic reviews and internal audits and, besides, they will monitor, with the adequate automated alert systems, the activities of individuals/algorithms trading and the Trading activities of clients taking account of orders submitted, modified and cancelled as well as transactions executed.

Guideline 7- Trading venues: Direct Access Market (DMA) and Sponsored Access (SA).

Trading venues should have rules and procedures which seek to ensure that DMA/SA is compatible with fair and orderly trading. The members, participants or users to offer DMA and/or SA are solely responsible for all messages and orders entered under their trading codes (ID Code), and may be subject to interventions (including cutting access) and sanctions for any breaches of the rules and procedures in respect of those orders. Trading venues: a) will require members/participants/users to have adequate systems and effective controls including pre- and post-trade controls, to conduct due diligence on clients to which they provide DMA/SA; b) could refuse, in some circumstances, a request from a member/participant/user to allow a client to be provided with DMA/SA; c) will monitor clients DMA/SA orders; and d) will have potential interventions over SA (suspension or withdrawal if is not consistent with its rules for fair and orderly trading, freezing orders from a person trading through SA separately from the rest of the orders and review of internal risk control systems in relation to their DMA/SA clients).

Guideline 8- Investment firms: DMA/SA clients.

Investment firms will have in place policies and procedures so that the trading of DMA/SA clients complies with the rules of the relevant trading platforms to which the order of such clients are submitted. Due diligence on prospective DMA/SA clients should be appropriate to the risk posed by the nature of the clients and the scale and

complexity of their prospective trading activities, and will cover training and competency of individuals entering orders, access controls over order entry, allocation of responsibility for dealing with actions and errors, the historical trading pattern of the clients and their ability to meet their financial obligations. Orders will be subject to the parameters of the pre-trade controls described in guideline 4, and the DMA/SA clients should not be able to modify them. An SA client should never be able to send an order to a trading platform with the order passing through pre-trade controls of the investment firm (prohibition of “naked” or “unfiltered” market access in MiFID). The monitoring of orders should be carried out under guidelines 4 and 6. Investment firms should establish clarity about the rights and obligations of both parties in relation to the DMA/SA service.

If you want to read the document, please do click on: http://www.esma.europa.eu/system/files/2011-456_0.pdf