Getting it right

Automated trading and the challenges for the stability and integrity of our markets

Speech Ronald Gerritse, chairman of the executive board AFM
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(Check against delivery).

Ladies and Gentlemen,

Good morning and welcome. Let me start by saying that it is good to see that FOW has again chosen Amsterdam for its annual get-together on equity options trading. This will hopefully be the start of a great new tradition.

As you know, Amsterdam can be considered the cradle of equity options trading, and we are fortunate to have, until the present day, a vibrant community of market participants here who are active in this part of the market.

It is also gratifying that you have invited the AFM to say a few words at the start of what will hopefully be a fruitful conference. We are meeting at a time that the legitimacy of several financial market activities is under serious challenge. This is cause for concern, not just for you as market participants, but also for us as financial supervisors, and indeed for all of society.

We believe that the financial markets can, and should, make a useful contribution to the real economy and society as a whole. Provided they are structured well, the financial markets facilitate the effective allocation of risk capital to the places where it is of most use, and allow for the efficient reallocation financial risks. These are useful and necessary functions in the complex global economy in which we live today.

These key functions of the financial markets require the skill and commitment of a very diverse mix of market participants, including yourself. They also require the justified confidence of all market participants, including retail investors, and the public at-large, in the fair and orderly functioning of the market. This is where we as financial supervisors come in. But I cannot stress enough that assuring the stability, transparency and integrity of the European securities markets is not the burden of financial supervisors alone. You, as market participants, also have an important role here.

This is why I welcome this opportunity to speak with you today on how we can better assure the stability and integrity of the European financial markets. At this time, Europe is undertaking a comprehensive review of the structural and regulatory framework for the European financial markets, contained in MiFID. This review comes in the aftermath of two traumatic financial crises (credit and sovereign debt). Also, it follows in the slipstream of significant technological innovations that have changed the face of secondary markets trading forever. There is a strong feeling in Europe that these two key developments warrant a close reassessment of the market practices and activities that have emerged or grown over the past few years.

So, let's talk about MiFID-2. In doing so, I would like to specifically focus on the MiFID-2 proposals on algorithmic trading. In addition, I will also talk with you about what ESMA is doing already right now to address automated trading under the existing MiFID-1 framework.

As you may be aware, the AFM has been a very active participant in the international debate on high frequency trading and other forms of automated and algorithmic trading. We have several major HFT players in our market who are, incidentally, no stranger to the world of equity options trading. Consequently, we feel a particular responsibility to address the concerns that have been raised with regard to HFT – squarely, but fairly. If we get it right, MiFID-2 can achieve that goal as well. We believe the original Commission proposal looks very promising, although in our opinion it will still need some tweaks here and there.

MiFID-2: process

First a few words on the process of the MiFID review. What we commonly designate as "MiFID-2" actually consists of two legislative proposals: one for a directive (MiFID) and one for a regulation (MiFIR). These were published by the Commission in October 2011. Currently, the Council Working Group negotiations on the proposal are ongoing. The AFM is involved in these negotiations in an advisory role to the Netherlands ministry of Finance.

Earlier, we have also been closely involved in the preparatory steps leading up to the MiFID-2 proposal. For example, we have helped to draft the original CESR MiFID advice to the Commission. We also were closely engaged in the ESMA work on automated trading, which has found its way into the new MiFID systems and control requirements around algorithmic trading.

Under the EU system of co-legislation both the Council and the European Parliament play an equal role in the legislative process. The European Parliament has just recently presented its first views on the MiFID-2 proposal in late March.

As you will probably be aware, there are three separate stages in the negotiations: First the Council and the EP each need to reach agreement amongst themselves. Then these two versions will need to be reconciled in the trilogue between the EP, the Council and the Commission. The ambition is for political agreement to be reached by the end of 2012, but if finding a workable compromise proves difficult, the trilogue may well stretch out into 2013. After this, level-2 measures (delegated acts and ESMA Binding Technical Standards, BTS) will need to be developed. Finally, all measures will need to be implemented by the Members States into their national legislation. (Although this will not be necessary for the items contained in MiFIR, which as a regulation will have direct effect).

Taking into account all of these steps, it can be expected that the moment MiFID-2 will actually come into force will be in the course of 2014 at the earliest. Depending on how soon political agreement can be reached, it may possibly be even later. While that sounds a long way off, I strongly believe it would be wise for you as market participants to follow the discussions around the MiFID review closely, and to prepare for the changes it will require from you.

I am conscious that given the complexity of the European legislative process, the exact status of the proposals that you hear about may sometimes not be entirely self-evident. Take, for example, the recent report by the MiFID rapporteur of the ECON Committee (the EP committee responsible for financial markets policy). It is important to be aware that this report does not yet constitute the stated position of the whole parliament, let alone of the EU. It is a first step towards an agreed position, which first needs to be reached within the ECON Committee itself, and later in the parliament as a whole in plenary session. This means that this initial report will be heavily amended at several stages in the coming few months before an agreement will be reached.

So, the process is still very much in flux, and you can reasonably expect the final outcome to look quite a bit different from the original proposal. However, this is no reason for complacency. Certain paradigms are clear, and market participants will have to take those into account. Reading through the lines, the message from both from the Commission and from the democratically elected representatives of the European people is plain and simple: there exist real concerns with certain activities in the financial markets, including some in which many of you in the audience are engaged.

MiFID-2: proposals around algorithmic trading (a)

Let us now turn to the substance of the proposals around what the MiFID-2 proposal terms "algorithmic trading". This is a very broad category, which captures all forms of trading where a computer algorithm automatically determines trading activity, with no or minimal human intervention. One type of algo trading is high frequency trading, but there are many others. We very much welcome this broad definition, because *all* types of automated trading can contain comparable risks. For that reason, we are concerned by efforts (mainly coming from the buy side) to limit the scope of "algo trading" to HFT only. (One only needs only to remember the flash crash in the US, which was started by an order execution algo of an institutional investor, to see that limiting the scope is undesirable).

At the AFM we believe that the use of advanced trading technology can serve a useful purpose and that it has brought significant efficiencies and benefits to market participants. However, it also contains potential sources of risk, both for the orderly functioning and for the integrity of the markets. These risks will need to be addressed – adequately, but wisely. The clock cannot be turned back.

The highly automated nature of our financial markets requires a robust strengthening of the systems and controls framework throughout the trading value chain. We believe the MiFID proposal contains a great number of very sensible measures in this area. We wholeheartedly welcome these.

We also strongly support the new requirement that all members of an exchange will need to be authorised as a full MiFID firm. In an automated trading environment all exchange members can have a significant impact on the market, and for that reason it is certainly appropriate to require that such firms are authorised. My expectation is, therefore, that in the future we will be able to welcome more than one of you as AFM-supervised firms.

MiFID-2: proposals around algorithmic trading (b)

Still, we also have a few concerns with the original proposal. I will share these with you in a bit. But let us first have a look at some of the suggestions prepared by the MiFID rapporteur of the EP. Here we see more reasons for concern, and we hope that these will be addressed going forward. Let me name a few;

- The provision of direct market access (DMA) and sponsored access (SA) would be prohibited. We certainly do not agree with this proposal. It would tilt the level playing field, and would threaten the equitable access to the financial markets. We see DMA as a legitimate way for market participants to share the cost of maintaining a sophisticated (and expensive) connectivity infrastructure among a greater number of persons. Making DMA impossible would have undesirable effects for the liquidity of our markets, something that is very much on the mind of policy makers. (We will get to this shortly). By contrast, we very much welcome the original Commission proposal on this issue, which creates additional safeguards around the provision of SA and DMA by investment firms.

- Another concern we have with the initial EP proposal relates to the fee structures of trading venues. We certainly agree that these need to be transparent and fair. With our counterparts in ESMA we are doing work in this area at this very moment. However, we believe requirements on fee structures should not be used as a way to prohibit or penalise the updating of orders for risk management reasons. That is also the reason why we are opposed to the idea of introducing an arbitrary minimum order resting time of 500 milliseconds. Large scale messaging does not need to be a problem per se, as long as traders are not implementing abusive strategies and the right systems and controls are in place. This includes having sufficient capacity available, and effective stress and development testing.

We believe that proposals as the ones I just mentioned are trying to treat the symptoms rather than the underlying problems. In our opinion, this is also true for the so-called market making proposal for algorithmic trading strategies in the original MiFID-2 proposal (article 17.3), which I would like to address here in more detail.

This proposal would require from all algorithmic trading strategies to provide liquidity on a regular and ongoing basis at all times, regardless of prevailing market conditions. Thus, it would force each and any market participant who uses algorithmic trading strategies to operate as a market maker. We believe this proposal disregards the different roles and responsibilities of different types of market participants. It denies the fact that algorithmic trading strategies are very widely used, and for a very broad range of purposes. It is not realistic, nor desirable, to demand that market participants should provide liquidity on a continuous basis when this runs contrary to their business model, skills, as well as their obligations towards their clients.

Theoretically, one could imagine narrowing the scope of the market making requirement to capture only strategies used in high frequency trading. However, we have strong concerns that defining high frequency trading for legal purposes will be inadequate and will invite regulatory arbitrage. (The EP report also has tried to develop a legal definition of HFT, in our opinion with an equally unsatisfactory outcome). Also, any potential narrowing of the scope of the proposal will still not address the fundamental concerns that exist.

The proposed requirement to provide “continuous” liquidity is very strong. It would be significantly more stringent than the requirements that currently exist for traditional market makers or liquidity providers with a formal contractual relationship with an exchange. Traditionally, market making has always been a remunerated service (rather than an altruistic activity), where obligations and risks are balanced by certain rewards. We believe it cannot be expected from market participants that they will perform this service under all circumstances and without recourse when they cannot expect some predefined compensation for it. The requirement to provide liquidity regardless of market conditions exposes market participants to potentially severe market risk. They would be asked to “catch a falling knife” when the market turns against them. This does not help market robustness or financial stability, while that should be our aim.

We would prefer an alternative approach. The underlying policy goal is to assure that there are adequate safeguards in place to guarantee an adequate level of liquidity provision on trading venues at all times. I just need to remind you of the flash crash, to see where this justified concern comes from. We agree that the availability of sufficient liquidity is desirable for the purpose of the orderly functioning of the markets. Also, we recognise that currently not all venues (e.g. MTFs) have formal arrangements in place that address this concern.

Consequently, we think that it would be good to include in MiFID-2 a stronger framework around liquidity provision. This could be achieved by directing it towards trading venues. Venues have a key interest in assuring the availability of adequate and sustainable liquidity on their platforms, and are also well positioned to assess how this liquidity can best be provided. Therefore, we favour a requirement for trading venues to have in place clear and transparent programs that reward those who provide liquidity on a sustainable basis on that platform, on the basis of a realistic set of obligations and incentives around the activity of market making. We believe this alternative approach offers a realistic and constructive response to the existing concerns about liquidity provision in an automated trading environment.

ESMA guidelines on automated trading

MiFID-2 will strongly affect you in the future, but the risks that accompany automated trading are very much something of the here and now. For that reason, ESMA has recently developed guidelines on systems and controls for automated trading. Market participants will need to comply with these guidelines as per May 1. These guidelines build on existing MiFID principles. However, they are more specific on what we, as European supervisors, expect from market participants in order for them to comply with the regulatory framework. The guidelines will give you a foretaste of the proposed MiFID measures around the systems and controls for algorithmic trading.

My suggestion to you would be to undertake a robust gap analysis of your systems and processes vis-à-vis the guidelines. This will be especially important for non-authorised firms that are members of an exchange, for market participants who make use of DMA, and for market participants who use the services of independent software vendors (ISVs):

- Firms that are not authorised as investment firms or credit institutions, but who are a member of an exchange, will be affected by the requirement that exchanges should apply the ESMA guidelines when assessing the suitability of the systems and controls of non-authorised members. This may require additional compliance actions from existing non-authorised exchange members. The AFM will take this requirement very seriously in its exchange supervision. So if you are a non-authorised exchange member, my counsel to you would be to take proactive steps in order to assure compliance with the guidelines.

- The guidelines will affect non-authorised firms who make use of SA/DMA services in a comparable manner, but then via our supervision of SA/DMA providers.

- Making use of the applications of independent software vendors for trading or connectivity purposes constitutes a form of outsourcing of key functions. As a firm you should make sure that the software applications you are using do not compromise your ability to discharge your regulatory obligations. If your trading activities fall under the scope of the guidelines and you make use of ISVs, then I would suggest that you have a good discussion with your vendors in order to assure that you are indeed compliant.

Conclusion

Let me sum up. We need to keep our eyes on the ball and focus on what is essential: to assure that our financial markets are resilient (both in terms of integrity and stability), so that they can accommodate the highly automated nature of trading. Many of the MiFID-2 proposals will bring us closer to that goal, however some of the proposals that have been suggested distract from it.

Obviously, we are committed to do what we can to make MiFID-2 work. However, you as market participants have a role here as well. Policy makers and politicians in Brussels are sincere in their commitment to making the markets more robust. So are we, and I hope, so are you as well. However, we have only one chance to get it right. It would really serve no one when public animus against, for example, HFT would lead to measures that will not help market safety or efficiency.

Just arguing that HFT has tightened spreads and aids liquidity is not enough. Policymakers and politicians want to see from traders that they have a realistic sense of both the benefits and potential risks of HFT. The concerns that people have are very real. Rather than waving them away, market participants will need to show that they are taking responsible and proactive action to address these concerns. Not only from the perspective of protecting their own P&L, but also in order to maintain market stability and integrity. Ducking the issue will simply not make it go away.