FERNANDO RESTOY'S RESPONSE TO DISCUSSION QUESTION 1 TOPIC 2:
NEW TRADING STRATEGIES (HFT AND ALGORITHMIC TRADING).

Regulators on both sides of the Atlantic have been looking at these new trading strategies. The European Commission, in particular, proposed a draft law, known as MiFID II, with a focus in this space. What are regulators' key concerns? What have policy makers and regulators proposed? How do the proposals address the concerns?

A) What are regulators' key concerns?

Response:

Market developments since MiFID I have challenged the current regulatory framework. Technological developments present opportunities and challenges.

- **Opportunities.**

* Rethink positive effects on market liquidity

- Challenges.

* Potential pull out of the regular long term oriented participants (professionals and retail).
* There is an increase of the number of Dark Pools. HFTs are expanding their activity to the Dark Pools too.
* Potential threats for the orderly functioning of markets: volatility, market abuse.
* New developments in oversight and monitoring of such activities by CAs are necessary and those developments are rather costly.

B) What have policy makers and regulators proposed?

* Policy makers and regulators have not yet agreed an accepted definition of what constitutes HFT. Policy makers and regulators feel that a deeper analysis is needed. In particular the new trends in trading should be carefully analyzed including the consequences of the increasing use of automated trading, the possible consequences of increasingly sophisticated algorithms. This analysis will facilitate a categorization of the different strategies applied and the different types of traders.

* Need for a gradual approach in order to decide which areas could require additional regulatory and supervisory measures.

Regulatory developments in Europe:

New Proposal MiFID: MiFID II includes provisions in order to adequately deal with the potential threats that have been identified (article 17 and 51 of MiFID II).

- Article 17 of the draft Directive states that Investment firms shall have in place:

    - effective systems and risk controls to ensure that their trading systems are resilient and have sufficient capacity,
    - are subject to appropriate trading thresholds and
    - limits and prevent the sending of erroneous orders to the system.
    - The obligations of this article 17 will also be applicable to all Pension Funds, Insurance companies or Managers of CIS when engaging in HFT.
- However, the most important is paragraph 3 of article 17 in the current draft of MIFID II which states that an algorithmic trading strategy shall be in continuous operation during trading hours. This provision tackles the problem of lack of liquidity when market conditions abruptly change in a very short period of time. Nevertheless, there will be some exceptions for those HFT that are focusing on management orders or on order execution.
- Article 51 requests that Member States shall require a regulated market to have in place effective systems, procedures and arrangements to ensure its trading systems are resilient, have sufficient capacity to deal with peak order and message volumes, and are able to ensure orderly trading under conditions of market stress.
- Article 51 also mentions that there will be a further detailed legislation dealing with issues like trading halts, co-location or trading fees.

- As a matter of fact, this MIFID II is not expected to come into force before the end of 2013 or even later. Consequently, ESMA has issued a Guideline which sets out the ESMA member's view of appropriate supervisory practices in this particular area. The purpose of these guidelines are to ensure common, uniform and consistent application of MiFID and MAD as they apply to the systems and controls required of trading platforms and Investment Firms in an automated trading environment and in relation to the provision of Direct Market Access and Sponsoring Access. This guideline is bringing forward most of the requirements included in MIFID II.

Market participants should be able to comply with them from 1st May 2012.

C) How do the proposals address the concerns?

Response:

Both proposals (ESMA guidelines and MiFID II) try to establish regulatory and supervisory measures in order to tackle the specific risks that these new technological developments imply not only from an organisation point of view but also in minimising the situations where the liquidity is suddenly withdrawn.

In the ongoing debate on MiFID II and its further practical development, there may be a need to further reflect on several issues:

- Need to adopt specific requirements for specific types of algorithm traders (such as HF)
- Revise the scope of market making obligations
- Think on how to cover higher costs of supervision