

Germany Enacts High-Frequency Trading Act

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Act regulates high-frequency trading firms and certain trading activities to address concerns about their potential impact on market stability.

On 28 February, the German Parliament (*Bundestag*) approved the "Act for the Prevention of Risks and the Abuse of High Frequency Trading" (*Entwurf eines Gesetzes zur Vermeidung von Gefahren und Missbräuchen im Hochfrequenzhandel*) (HFT Act). The HFT Act is aimed to curtail high-frequency trading (HFT) on German trading venues and to submit certain algorithmic trading strategies to regulatory supervision. This LawFlash provides a brief summary of the HFT Act with respect to its content and the current status of the legislative process. Trading firms that are engaged in algorithmic trading on German trading venues need to review the new regulatory requirements imposed by the HFT Act, in particular the new licensing requirements, and ensure their compliance within the transitional periods provided by the HFT Act.

Background

In July 2012, Germany decided to move forward with a set of new rules on HFT, further solidifying Europe's response to concerns regarding high-frequency traders and their potential impact on market stability.

The German initiative must be viewed within the context of the currently discussed reform of the Markets in Financial Instruments Directive (MiFID). MiFID II, which is expected in 2015, will introduce, among other things, a specific legal framework for algorithmic trading activities. As with its legislation on naked short selling, Germany has been a frontrunner in regulating HFT, and its HFT Act precedes and—to some extent—preempts legislation at the **European Union (EU)** level. Consequently, the German HFT Act will have to be revised and adjusted when the European regulations become effective.

Status of the HFT Act

A first draft of the HFT Act was presented by the German Ministry of Finance (*Bundesministerium der Finanzen*) on 30 July 2012. A slightly amended version of this draft was adopted by the German government on 26 September 2012. The HFT Act was approved by the German Parliament on 28

February 2013. In order to become effective, the HFT Act must be signed by the federal president and then published in the *Federal Law Gazette (Bundesgesetzblatt)*. This process is expected to be completed within the next few weeks. The effective date of the HFT Act will be the day following its publication.

Summary of the HFT Act

License Requirement for HFT Firms

The HFT Act will amend the German Banking Act (*Kreditwesengesetz*) and introduce a license requirement for proprietary trading firms that are using certain HFT strategies, i.e., HFT firms will have to be licensed as financial services institutions.

The expanded definition of "proprietary trading" under the HFT Act will be broad and aimed to cover most forms of proprietary trading using algorithmic trading. The HFT Act states that "any institution that engages in the purchase or sale of financial instruments for its own account as a direct or indirect member of a German regulated market or multilateral trading facility by using computers, which are able to recognize changes in the market price in a split second, make autonomous market decisions following predefined rules and choose and transfer the adequate order parameters, even when not offered as a service for others", will be covered by the license requirement.

The licensing requirement will also apply to foreign firms that are trading directly or indirectly through a direct exchange member on a German-regulated market or a German multilateral trading facility.

Firms that are already licensed in Germany or in another EU or European Economic Area (EEA) member state for proprietary trading do not need to apply for a separate license for HFT in Germany but can benefit from the European passport rules, which allow such firms to rely on the license obtained in one European member state for their activities throughout the EU. The HFT Act, however, does not provide for an exemption from the licensing requirement for firms that hold a license from a regulatory authority outside the EU/EEA area.

There will be a transitional period of three months after the enactment of the HFT Act, during which concerned institutions must submit their license applications to the Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht* or BaFin). For firms domiciled outside the EU/EEA, this period is extended to nine months.^[1]

Regulation and Supervision of HFT Firms

As mentioned above, HFT firms will have to be licensed as financial services institutions under the German Banking Act to become subject to the supervision by the BaFin. Consequently, they will become subject to the general regulatory framework applicable to investment firms under the German Banking Act and the German Securities Trading Act (*Wertpapierhandelsgesetz*). These regulations include minimum capital requirements, comprehensive obligations with respect to organizational and risk-management matters, fit and proper requirements for management and qualifying shareholders, and numerous reporting and disclosure requirements.

In addition, the BaFin and the Trading Surveillance Office of the respective trading venue may request from HFT firms information regarding their algorithmic trading activities, including the systems used, details of their strategies, and applicable trading parameters and limits. The respective exchange supervisory authorities may prohibit certain trading strategies to prevent violations of

applicable laws or undesirable developments in trading.

Specific Organizational Requirements for HFT Firms

The HFT Act introduces specific organizational requirements for HFT firms, i.e., firms that trade through the use of computers that determine the different parameters for orders automatically, including timing, price, quantity, and the details of how an order is executed. Under the HFT Act, such firms must satisfy the following requirements to ensure that market distortions cannot occur:

- The trading system must have sufficient capacity and appropriate trading thresholds and limits.
- The submission of erroneous orders must be prevented, and the system must otherwise function in a way that prevents the creation or perpetuation of a disorderly market.
- The trading system cannot be used for trading that violates applicable market-abuse rules.
- Each HFT order must be "earmarked" as such and must identify the algorithm that has been used to create the order.

After the enactment of the HFT Act, there will be a transitional period of six months for HFT firms to comply with the new organizational requirements.

Regulation of Certain Trading Methods

The HFT Act introduces a number of provisions aimed at regulating certain trading patterns, including the following:

- An adequate ratio between purchase and sale orders and transactions that are actually executed must be ensured in order to avoid "quote stuffing" and other behaviours that block trading systems and impede orderly trading and price discovery.^[2]
- Trading venues must charge additional (i.e., punitive) fees for certain excessive trading patterns.
- Trading venues must ensure that orderly fixing of quotations is also possible in cases of substantial volatility.
- Trading venues must provide for adequate minimum tick size for all traded financial instruments.

The HFT Act does not provide for a minimum resting time or a market-making obligation for HFT firms, which have been proposed to be introduced by MiFID II.

^[1]. There is a dispute in German legal literature as to whether a physical presence in Germany is required in order to obtain a license. Whereas the wording of the German Banking Act does not require such physical presence and allows cross-border financial services, the BaFin has, in the past,

expressed the view that non-EEA institutions must establish a presence in Germany. It remains to be seen whether this will also be required for pure

proprietary HFT firms.

^[2]. The HFT Act leaves it to the respective trading venue to further specify certain types of financial instruments and the conditions under which orders will be considered "economically reasonable".

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