



## **OPINION OF THE EUROPEAN CENTRAL BANK**

**of 13 December 2012**

**on high frequency trading**

**(CON/2012/107)**

### **Introduction and legal basis**

On 12 October 2012, the European Central Bank (ECB) received a request from the German Federal Ministry of Finance for an opinion on a draft law on the prevention of risks and abuses in high frequency trading (hereinafter the 'draft law').

The ECB's competence to deliver an opinion is based on Articles 127(4) and 282(5) of the Treaty on the Functioning of the European Union and the sixth indent of Article 2(1) of Council Decision 98/415/EC of 29 June 1998 on the consultation of the European Central Bank by national authorities regarding draft legislative provisions<sup>1</sup>, as the draft law relates to rules applicable to financial institutions insofar as they materially influence the stability of financial institutions and markets. In accordance with the first sentence of Article 17.5 of the Rules of Procedure of the European Central Bank, the Governing Council has adopted this opinion.

### **1. Purpose of the draft law**

The draft law is intended to counteract the specific risks of algorithmic high frequency trading. To that end, the draft law amends the Law on banking, the Law on the stock exchange, the Law on securities trading, the Law on investment and further related laws.

In that context, the definition of the term 'proprietary trading' is expanded to include high frequency trading (HFT), which uses algorithmic-based trading, generating purchase and sale signals within seconds and provides for the holding of positions for a very short time. This aims to eliminate a supervisory loophole and to bring high frequency traders under the supervision of the Federal Financial Supervisory Authority (BaFin).

In addition, algorithmic trading (AT) is made subject to stricter requirements, under which investment services providers, investment trusts and self-managed investment companies which conduct AT are to ensure that in the future, from an organisational point of view, their trading systems are designed in such a way as to avoid market disruptions.

Furthermore, certain trading practices which are intended to disrupt or delay the functioning of trading systems or to mislead other trade participants are included under the definition of market manipulation.

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<sup>1</sup> OJ L 189, 3.7.1998, p. 42.

Moreover, in addition to the introduction of a fee for excessive use of trading systems, an obligation is introduced whereby trade participants are to guarantee an appropriate ratio between (1) orders placed, changes to and cancellations of orders, and (2) business transactions that are actually concluded. A minimum tick size is introduced in order to counteract the trend towards ever smaller minimum tick sizes. In order to prevent a move towards multilateral trading systems to avoid such regulation, the draft law is also applicable to multilateral trading systems.

The draft law also strengthens the intervention rights of the supervisory authority for the stock exchange and implements a specific right to receive information and to submit proposals.

## **2. General observations**

- 2.1 The ECB welcomes the draft law as it aims to curb risks for financial stability and to contain market manipulation caused by high frequency trading.
- 2.2 The ECB points out that national legislation will need to be in line with forthcoming European Union legislation, in particular (1) the proposal for a directive on markets in financial instruments repealing Directive 2004/39/EC of the European Parliament and of the Council<sup>2</sup> (MiFID), (2) the proposal for a regulation on markets in financial instruments and amending Regulation on OTC derivatives, central counterparties and trade repositories<sup>3</sup> (MiFIR), (3) the proposal for a directive on criminal sanctions for insider dealing and market manipulation<sup>4</sup>, and (4) the proposal for a regulation on insider dealing and market manipulation (market abuse)<sup>5</sup>. In that context, the ECB refers to its opinion on these proposals<sup>6</sup>.

## **3. Specific observations**

- 3.1 The ECB welcomes the fact that the draft law refers to specific cases of market manipulation, referring to new trading techniques such as AT, which includes HFT. As stated in paragraphs 10.1 and 14.3 of the aforementioned ECB opinion, although AT practices may have legitimate purposes, they might also jeopardise the liquidity and efficiency of financial markets, particularly in times of market stress, as they could disturb the normal functioning of the market and increase volatility, which would be contrary to the public interest.
- 3.2 The ECB welcomes the establishment of a special right to information for the stock exchange supervisory authority and also for the Trading Surveillance Office aimed at improving the monitoring of companies conducting AT. The ECB also supports the proposal under which HFT companies which are not credit institutions or other financial services institutions would be brought under the supervision of BaFin. In this regard, the ECB reiterates that in its Opinion CON/2012/21

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<sup>2</sup> COM(2011) 656 final.

<sup>3</sup> COM(2011) 652 final.

<sup>4</sup> COM(2011) 654 final.

<sup>5</sup> COM(2011) 651 final.

<sup>6</sup> Opinion CON/2012/21. All ECB opinions are available on the ECB's website at [www.ecb.europa.eu](http://www.ecb.europa.eu).

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it considered that all entities engaged in AT on a professional basis should be considered to come within the definition of investment firms and thus fall under the scope of the MiFID and be subject to supervision and monitoring of their activities by competent authorities. Ensuring comprehensive coverage of all entities professionally involved in HFT and AT would limit potential circumvention of the proposed rules.

- 3.3 The ECB notes that the draft law introduces an obligation for appropriate marking of orders. Such provisions may need to be adjusted in light of the requirements under the proposed MiFIR and relating to transaction reporting details, with the introduction of a designation to identify the computer algorithms within the investment firm responsible for the investment decision and the execution of the transaction. In this regard, and as highlighted in Opinion CON/2012/21, to facilitate cross-market surveillance and to prevent and detect market abuse, such unique identifiers should be developed for the identification of trades generated by any AT within and across trading platforms. Furthermore, the introduction of a trader ID could be considered in order to be able to assign each order and each transaction to the person responsible within the investment firm.
- 3.4 The ECB welcomes the proposed granting of powers to the stock exchange supervisory authority to prohibit the use of a specific algorithmic trading strategy, notably with a view to preventing breaches of stock exchange regulations and trading orders and to eliminate abuse. Opinion CON/2012/21 supported the empowerment of the European Securities and Markets Authority to temporarily prohibit or restrict certain types of financial activity or practice with a view to addressing a threat to the orderly functioning of financial markets or the stability of whole or part of the financial system.
- 3.5 In line with the views expressed in Opinion CON/2012/21, the ECB welcomes the proposed introduction of appropriate organisational safeguards for trading venues, namely (i) volatility interruptions, (ii) an appropriate ratio between orders that have been suspended and transactions actually conducted on a stock exchange, and (iii) an appropriate minimum tick size for traded financial instruments.
- 3.6 The ECB notes that the draft law introduces compulsory fees for the excessive use of stock exchange trading platforms, which are to be regularly reviewed by the stock exchange supervisory authority within the scope of its supervision. While welcoming provisions limiting the excessive use of suspended orders, it is important that such measures are clearly articulated, together with those to be provided for under the envisaged legislative proposal on the Financial Transaction Tax.

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This opinion will be published on the ECB's website.

Done at Frankfurt am Main, 13 December 2012.

[signed]

*The Vice-President of the ECB*

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