

WFE Response to ESMA on Algorithmic Trading

March 2021

Q10: Do you agree with ESMA's proposals above? Please elaborate!

The World Federation of Exchanges (WFE) agrees with ESMA's proposal to include users of direct electronic access (DEA) in the exemption from authorisation under MiFID, alongside others who trade on their own capital. On the basis that providers of DEA will themselves be regulated, either directly under MiFID or via a comparable regime in a third country, there is no need to maintain what amounts to duplicative regulation by having users in scope as well. To put it another way, it does not seem to us that an entity trading on its own capital – and therefore in principle exempted from authorisation requirements under MiFID – merits or requires supervision merely because that trading happens via DEA. We do, however, accept the premise that HFTs may raise different issues and should accordingly be subject to specific regulatory treatment.

Proportionality is the watchword here. An additional benefit of streamlining the provisions regarding DEA is that it will make for a more consistent approach across EU member states, which will in turn support a better model for cross-border business, ie, business between the EU and third countries.

Q28: Do you agree with ESMA's analysis that the circuit breaker mechanism achieved its objective to avoid significant disruptions to the orderliness of trading?

The World Federation of Exchanges (WFE) believes that circuit breakers did indeed contribute to orderly trading. This is admittedly hard to quantify, as it is not easy to measure the counterfactual (ie, what would have happened, absent the circuit breaker). But markets clearly did continue to function, through record volumes (and in spite of political interventions, including calls for markets to shut and damaging restrictions on legitimate short-selling activities).

The WFE has surveyed its members (globally – not just in the EU) as to the value of circuit breakers, in light of exchanges' and investors' experiences in early 2020, as financial markets adjusted to the 'pandemic economy' under the spread of Covid-19. We have concluded that, while the calibration of circuit breakers and other VCMs is and always will be subject to review and refinement, even the existence of a circuit breaker helps instill market confidence, because participants know in advance that there will be an opportunity to take stock when prices are moving particularly fast.

Unlike restrictions on short-selling, which deprive the marketplace of information, circuit breakers are part of the core tool-set and work with the grain of markets, by allowing the effective assimilation of developments when these are occurring at a more rapid pace than usual. This allows market participants to reflect on whether sharp moves in price constitute a justified repricing or overshoot. In the presence of automated trading, where systems may be extrapolating from the most recent trend and reinforcing it, this may be particularly helpful.

Q29: Do you agree that the requirements under Article 48(5) of MiFID II complemented by RTS 7 and the guidelines on the calibration of circuit breakers and publication of trading halts under MiFID II remain appropriate? If not, what regulatory changes do you deem necessary?

The World Federation of Exchanges (WFE) agrees that the requirements in MiFID (under Article 48(5), etc) remain appropriate. Crucially, they work at the level of principle, rather than quantitative prescription. This allows for tailored calibration that reflects the asset (or perhaps segment) and the specific market microstructure that applies thereto, ie, the manner in which price formation occurs. In this regard, we underline the fact that a fully regulated exchange is the only entity that combines closeness to the market and neutrality together with the incentives to ensure that the marketplace as a whole functions optimally.

WFE members firmly believe that circuit breakers have proved their usefulness over time. Research carried out by the WFE since the market volatility of early 2020 (mainly to take stock of the range of approaches globally) shows that exchanges and their customers value the ability to respond to acute surges in volatility. What the ‘pandemic markets’ provided was an opportunity to review calibration, illustrating the fact that levels and mechanisms may legitimately vary over time as well as by venue, asset or other factors.

Please note, though, that the market-structure situation in the EU does beg a major question. It is classically the case in EU equity markets that price formation happens on the primary venue, which in practice also takes responsibility for the orderliness of trading. With execution fragmented in the EU as a result of regulatory fiat, such that non-venue internalisers are now a significant part of the market-structure landscape, the same standards do not apply to certain entities that compete with primary venues for deal flow (while exploiting the latter’s price formation and market data). Policy makers should consider the many implications of the fragmented market structure, not least those related to volatility control mechanisms.

Q35: Do you agree with the need to improve the notification process in case of IT incidents and system outages? Beyond the notification process between NCAs and ESMA, which improvements could be done regarding communication of incidents to the public?

The MiFID regime rightly recognises that incidents may occur, despite the best intentions and efforts of any service provider.

Clear, concise and timely communication to market participants and the wider public is self-evidently desirable in an extraordinary situation. The World Federation of Exchanges (WFE) is currently investigating what protocols, approaches or techniques are in use, in order to identify potential synergies, bearing in mind the existing EU requirement for Regulated Markets to report incidents to national competent authorities. It remains the case, however, that outages are rare. This does not mean communication does not matter. But, equally, it is consistent with the fact that incidents will tend to be idiosyncratic, rather than always of the same type.¹

The moral is that the nature and timing of such communications will inevitably be a function of the exact issue at hand. As with cyber resilience and other matters of operational and enterprise risk, it is vital to recognise that identification and analysis of issues should always be the priority and that the management of the issue – including any related communication – should proceed from the specific situation. Moreover,

¹ Technically, this is an example of the ‘Anna Karenina principle’. The opening words to *Anna Karenina* are: “Happy families are all alike; every unhappy family is unhappy in its own way.” In relation to outages, one would say: ‘All functioning IT systems are alike. Each crashed system has crashed in its own way.’

while there should be no undue delay in restarting a service, a safe restart is even more important. Arbitrary turnaround times can provide a useful target but will work best on a 'comply or explain' basis, to ensure that they do not end up being counterproductive. In this context, implementing prescriptive requirements that are static and untailored for managing incidents in practice, with evolving threats, is unlikely to result in beneficial outcomes for resilience.

In the same vein, preparation for incidents of any kind should encompass certain defined scenarios but more important is the ability to 'flex' one's response and to have the agility and organisational capacity to deal with each situation as it arises.

Q36: Do you believe any initiative should be put forward to ensure there is more continuity on trading in case of an outage on the main market, e.g. by requiring algo traders to use more than one reference data point?

The World Federation of Exchanges (WFE) understands the logic of the question, and agrees that continuity of trading is highly desirable. The question as to whether to require use of more than one reference data point will, however, be a function of how well the alternative data points reflect the market in question. Fragmentation of markets can bring choice (and competition in terms of execution costs) but not all alternative venues generate (or are capable of generating) meaningful price discovery of their own, instead relying on 'main' venues to do so. The regulatory approach should factor in this possibility, expressed as principles, thereby allowing traders' arrangements to reflect real-world conditions.

Q50: Do you think that the introduction and functioning of speedbumps should be further regulated? If yes, which specific requirements would you like to be included in EU legislation?

As with circuit breakers (*on which, please see our response to questions 28 and 29*), the World Federation of Exchanges (WFE) counsels giving sufficient latitude to exchanges to determine the nature and application of any speedbumps'.

In this regard, we underline the fact that:

- i) a speedbump is a market microstructure tool, which will
 - a) work in conjunction with a matching algorithm at the core of the exchange's transparent price-formation process; and
 - b) be applied in those markets where an exchange judges it able to enhance that process.
- ii) Moreover, a fully regulated exchange is the only entity that combines closeness to the market and neutrality together with the incentives to ensure that the marketplace as a whole functions optimally.

We further note that the applicability of speedbumps may depend on the particular market *macro*-structure that prevails in a given jurisdiction. The key point, in any case, is that it is incumbent on the exchange operator to determine which tools and processes best serve the combined imperatives of investor protection, stability and efficiency of markets, consistent with its role as guardian of a key piece of market infrastructure.

There is little evidence as to experience with speedbumps specifically in Europe and we would suggest that any policy position should be anchored in such specificity. We certainly see nothing in the existing regulatory framework that suggests 'Level 1' regulatory restrictions should be placed on their use. Moreover,

restrictions could harm the ability of exchanges to innovate, affecting their ability to compete, and ultimately damage market functioning.

The appropriate course of action would therefore appear to be continued dialogue between venues, ESMA and the National Competent Authorities in EU member states regarding planned or actual use of speedbumps.