

Clients & Friends Alert

MiFID and MiFIR on Algorithmic Trading – and – Provision of Services AND Establishment of Branches by Third Country Firms

31 October 2011

Introduction

This is the sixth in our series of briefings on MiFID and MiFIR. Below, we describe new obligations set out in MiFID that apply to investment firms engaging in algorithmic trading to have in place risk control measures, and authorisation requirements for third country firms providing services into or establishing a branch within the European Union as set out in MiFID and MiFIR.

A. Algorithmic Trading

Key Points

- algorithmic traders will be required to provide continuous, ongoing liquidity;
- order routing systems are excluded from the definition of “Algorithmic trading”;
- investment firms operating as algorithmic traders must deploy a series of risk control measures, including trading thresholds and limits.

Legislative Provisions

1. *MiFID Article 4(30) (Definition)*: MiFID sets out an entirely new definition of “Algorithmic trading”, which “means trading in financial instruments where a computer algorithm automatically determines individual parameters of orders such as whether to initiate the order, the timing, price or quantity of the order or how to manage the order after its submission, with limited or no human intervention. This definition does not include any system that is only used for the purpose of routing orders to one or more trading venues for the confirmation of orders”.

2. *MiFID Article 17 (Algorithmic trading)*: Investment firms engaging in algorithmic trading will now be subject to a number of systems, risk and operational requirements:

(i) to operate and maintain “effective systems and risk controls” in order to ensure resilient systems and capacity. These controls must include trading thresholds, limits and methods to

Cadwalader, Wickersham & Taft LLP is a registered limited liability partnership established under the laws of the State of New York. The personal liability of our partners is limited to the extent provided in such laws. Additional information is available upon request or at www.cadwalader.com. A list of our partners, who are Solicitors or Registered Foreign Lawyers in England and Wales, is available for inspection at the above address. Regulated by the Solicitors Regulation Authority.

This memorandum has been prepared by Cadwalader, Wickersham & Taft LLP for informational purposes only and does not constitute advertising or solicitation and should not be used or taken as legal advice. Those seeking legal advice should contact a member of the Firm or legal counsel licensed in their state. Transmission of this information is not intended to create, and receipt does not constitute, an attorney-client relationship. Confidential information should not be sent to Cadwalader, Wickersham & Taft LLP without first communicating directly with a member of the Firm about establishing an attorney-client relationship.

prevent erroneous orders and other issues that contribute to disorderly markets, business continuity planning and effective anti-market abuse measures;

(ii) annually, the investment firm must provide their home state regulator with a description of its algorithmic trading strategies, details of the trading parameters and limits it deploys, its compliance and risk controls and details of tests performed on these systems;

(iii) algorithmic trading strategies must be “in continuous operation during the trading hours of the trading venue”. In addition, the strategy must post firm quotes in order to provide “liquidity on a regular and ongoing basis to these trading venues at all times, regardless of prevailing market conditions”;

(iv) investment firms providing direct electronic access to trading venues must put in place systems and risk controls to monitor and ensure the suitability of end-users, and to prevent those end-users exceeding trading and credit thresholds.

B. Third Country Firms

Key Points

- third country firms may only provide services into or establish a branch in the European Union if a determination of equivalence has been made regarding the third country’s regulatory system;
- third country firms may only provide services to eligible counterparties;
- third country firms may only interact with retail customers through an authorised branch.

Legislative Provisions

1. *MiFIR Articles 36 – 39 (Provision of Services Without a Branch by Third Country Firms)*: Third country investment firms may only provide services to eligible counterparties in the European Union if: (i) they are registered on that third country’s register of authorised firms; (ii) they are authorised in a jurisdiction that is “subject to effective supervision and enforcement ensuring a full compliance with the requirements applicable in that third country”; and (iii) there is a cooperation agreement in place between the relevant regulator and ESMA. Third country firms must apply to ESMA for a determination of whether or not they may provide services into Europe.

The European Commission will adopt decisions relating to equivalence based on determinations of equivalence of third country prudential frameworks (capital requirements, organisational requirements, conduct of business rules and anti-market abuse provisions).

2. *MiFID Article 41 (Establishment of a branch)*: Third country firms intending to provide investment services or activities and any ancillary services through a branch require prior authorisation by the relevant local European regulator(s). Permission will depend on: (i) the

Commission having first adopted a decision to the effect that the third country's legal and supervisory arrangements ensure that authorised firms comply with legally binding requirements that have an equivalent effect to MiFID, MiFIR and the Capital Adequacy Directive; and (ii) a determination that the third country provides for "equivalent reciprocal recognition of the prudential framework applicable to investment firms authorised in accordance with this directive." Again, equivalence depends on effective supervision and enforcement requirements, capital requirements, organisational requirements and anti-manipulation measures.

Third country firms wishing to deal with retail customers in Europe may only do so through an authorised branch.

* * * *

Please feel free to contact any of the following Cadwalader lawyers if you have any questions about this memorandum.

Alix Prentice	+44 (0) 20 7170 8710	alix.prentice@cwt.com
Doron Ezickson	+44 (0) 20 7170 8525	doron.ezickson@cwt.com
Nick Shiren	+44 (0) 20 7170 8778	nick.shiren@cwt.com
Adam Topping	+44 (0) 20 7170 8529	adam.topping@cwt.com
Ramona Simms	+44 (0) 20 7170 8543	ramona.simms@cwt.com