

ALLEN & OVERY

GERMAN HIGH FREQUENCY TRADING ACT – IMPACT ON NON-GERMAN TRADERS

On 15 May 2013, the new German High Frequency Trading Act (the “HFT Act”) has entered into force.

This Q&A outlines the impact of the HFT Act on non-German domiciled high-frequency traders trading on a regulated market or on a multilateral trading facility in Germany.

GENERAL

Why might I be affected?

The HFT Act imposes a licensing requirement on non-German domiciled high-frequency traders (“**Non-German HFT**”). Any provision of high-frequency trading in Germany in violation of such licensing requirement will be considered a criminal offence.

Who qualifies as a Non-German HFT?

A Non-German HFT is anyone

- using a high-frequency algorithmic trading technique
- to buy or sell financial instruments for its own account
- on a regulated market or a multilateral trading facility in Germany (“**German Trading Venue**”), and
- as a direct or indirect participant of such German Trading Venue

without being domiciled in Germany.

DETAILS RELATING TO THE DEFINITION OF A NON-GERMAN HFT

What is a high-frequency algorithmic trading technique?

A high-frequency algorithmic trading technique is characterised by

- the use of infrastructures intending to minimise latency times (eg the use of a data connection to the matching machine of the market with the largest bandwidth offered (current state: 10 Gigabit/s) in combination with either a server in a co-location or the use of proximity hosting),
- a system determination of individual orders, quotes and/or cancellations generated and issued by the system without human intervention (eg the algorithm must itself issue binding orders/quotes/cancellations and does not only give indications to a human trader; mere order routing systems are not considered to issue such orders, quotes or cancellations), and
- high intraday message rates which constitute orders, quotes or cancellations (75,000 messages per trading day on annual average based on 2 messages per second per trading participant).

The German Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht* – “**BaFin**”) reserves the right to adjust the above thresholds on intraday messages from time to time.

What is meant by buying or selling financial instruments for one's own account?

The purchase and sale of financial instruments on an own account basis comprises all forms of dealing for own account, in particular, but not limited to, proprietary trading. The provision of high-frequency trading need not be a service for a client. Dealing for own account should also cover the provision of services as riskless principal in cases in which the trader enters into identical back-to-back transactions.

The provision of discretionary individual portfolio management and commission agency however does not amount to own account dealing. Individual portfolio management is the provision of services for a client under a power of attorney granted by the client to manage the client's account. In a commission agency relationship the client (as principal) instructs its agent (the trader) to purchase or sell financial instruments in the agent's own name for account of the client (as principal).

According to the German legislator's reasoning, high-frequency trading shall only be covered by the HFT Act to the extent that such trading activities are rendered for "own account". The HFT Act only amends the licensing requirement for the provision of own account dealing, which is distinct from the requirements applicable to the provision of portfolio management and commission agency. Therefore, we take the view that the provision of high-frequency trading by means of portfolio management and/or commission agency does not fall within the scope of the new licensing requirement.

What does trading on a German Trading Venue mean?

Trading on a German Trading Venue only covers trades that are actually matched by the matching machine of the German Trading Venue. Trades matched by any other venues will therefore not be within the scope of the HFT Act even if the traded financial instrument is admitted to trading on a German Trading Venue.

Who is a direct or indirect participant of a German Trading Venue?

Anyone using its own trading ID for trading on a German Trading Venue is considered a direct participant of such German Trading Venue ("**Direct Participant**").

Anyone trading on a German Trading Venue by means of using a Direct Participant's trading ID is considered an indirect participant ("**Indirect Participant**"). Direct access and sponsored access clients of a Direct Participant are hence considered Indirect Participants.

IMPACT OF THE HFT ACT ON NON-GERMAN HFT

What do I need to do if I am a Non-German HFT?

If you are domiciled/registered in the EU/EEA:

If you are licensed for the provision of own account dealing in your EU/EEA home jurisdiction

- and you use a passport for the provision of dealing on own account according to annex I section A (3) of Directive 2004/39/EC of 21 April 2004 on Markets in Financial Instruments (MiFID) into Germany:

No action is required.

- and not (yet) passported into Germany for the provision of such service:

You need to apply for a European passport for the provision of dealing on own account according to annex I section A (3) of MiFID by 14 November 2013.

If you are not licensed for the provision of dealing on own account in your home jurisdiction you first need to apply for an appropriate licence in your home country and then passport such licence into Germany by 14 November 2013. Please

note that the application for such licence is subject to various legal requirements in your home jurisdiction and the concerned regulation might significantly impact on your business.

Note: Entities which are for legal reasons not allowed to apply for a licence that covers the provision of dealing on own account and which hence cannot make use of a passport for their business in Germany (eg insurance companies, certain regulated funds) should discuss with BaFin if they can alternatively apply for an exemption order under section 2 paragraph 4 of the German Banking Act (*Kreditwesengesetz*) (“**Exemption Order**”). BaFin has confirmed that such entities should be eligible for an Exemption Order. An appropriate application needs to be filed by 14 November 2013.

If you are domiciled/registered outside the EU/EEA:

If you are a regulated entity in your non EU/EEA home jurisdiction and you already hold an Exemption Order of BaFin:

- at the latest by 14 February 2014, it needs to be clarified if the existing Exemption Order already covers high-frequency trading. Exemption Orders already in place for the provision of own-account dealing as of 15 May 2013 should cover high-frequency trading (at least where high-frequency trading was covered by the business description filed together with the original application for the Exemption Order). Such Exemption Orders should – according to BaFin – benefit from grandfathering.

If an Exemption Order is not available, you must

- apply for the establishment of a regulated branch with a licence for dealing on own account under the German Banking Act in Germany at the latest by 14 February 2014; or
- cease being a Non-German HFT by 14 February 2014 at the latest. This can be achieved either by not rendering high-frequency trading on a German Trading Venue anymore or by amending the terms upon which the high-frequency trading activities are rendered into Germany. BaFin clearly pointed out that – according to their envisaged administrative practice – they will not grant any (new) Exemption Orders for non-EU/EEA entities with regard to the provision of high-frequency trading as a Non-German HFT.

If you decide to establish a regulated branch in Germany you should take into account that various preconditions will be applicable to non-EU/EEA entities and such branch will basically be regulated as if it were a German regulated credit institution or investment firm. In this event, additional organisational requirements (specific compliance tools, documentation etc.) for HFT must be fulfilled.

Indirect Participants might also wish to discuss with their Direct Participants alternative forms of accessing German Trading Venues under which the Indirect Participant would not qualify as a Non-German HFT anymore.

What are the preconditions of an Exemption Order by BaFin?

BaFin has full discretion as to whether it grants an Exemption Order. Exemption Orders are not available for all non-EU/EEA jurisdictions. If you are in an eligible jurisdiction, you need to be subject to a sufficient level of regulation (i.e. a level of regulation comparable to the regulatory level in Germany). Therefore, BaFin should be contacted to clarify eligibility for an Exemption Order at an early stage. BaFin might give guidance on eligible forms of regulation.

Note: As already pointed out above please note that BaFin does not plan to grant Exemption Orders for non-EU/EEA entities with regard to the provision of high-frequency trading. Please note that it is discussed very controversial in the market if this is BaFin’s final word.

I need to submit an application for a licence, an Exemption Order or a passport within a certain timeframe. What will happen if I continue to conduct my high-frequency trading activities in Germany (i) before having filed such application and (ii) after I have filed such application?

In principle, you may continue your high-frequency trading activities until the end of the respective transition period as outlined above. For the time being, it is not clear whether you must have the general intention to apply for a licence, Exemption Order or passport within the given timeframe to benefit from the transitional regulation. However, this will

be clarified by BaFin within the next few weeks. If you have applied for a licence, an Exemption Order or passport within the given timeframe, you can continue your business unless (and by the time) the application for a licence or an Exemption Order was rejected by BaFin or your home regulator rejected the application for a passport. Following approval of the application you may continue to conduct high-frequency trading (subject to possible conditions set out in the approval decision).

SPECIAL IMPACT ON FOREIGN FUNDS AND ASSET MANAGERS

The application of the HFT Act on foreign funds and asset managers needs to be determined on a case-by-case basis. In the absence of express guidance by the German legislator, we – for the time being – take the view that a fund or asset manager is only subject to a licensing requirement if it in particular fulfils the following criteria cumulatively:

- The fund/asset manager is itself a Direct or Indirect Participant. For factual reasons it is unlikely that funds would have access to a German Trading Venues as Direct or Indirect Participants. However, asset managers often qualify as Indirect Participants and sometimes as Direct Participants if they are so-called “non-clearing-members” in Germany.
- The fund/asset manager renders high-frequency trading by “dealing on own account”. In particular Indirect Participants should check their legal documentation for the qualification of the services rendered. There might be good arguments that some Indirect Participants do not deal for their “own account” but for the account of funds and/or other investors. This might in particular depend on the way the fund and the asset manager is established (eg is the fund a corporate entity with an own legal personality like a Luxembourg SICAV? Is it managed internally or externally?).

In case you qualify as Non-German HFT, you are a regulated entity domiciled in the EU/EAA and you cannot apply for an EU-passport, BaFin should be contacted to determine if an Exemption Order would be granted (upon application by the fund/asset manager, see paragraph “*What do I need to do if I am a Non-German HFT?*” above).

ADDITIONAL REMARKS/DISCLAIMER

Please note that high-frequency traders domiciled in Germany are subject to additional and partially deviating rules and provisions not outlined in the Q&A. In addition, German Trading Venues need to amend their rules in order to comply with the HFT Act. Such amendments are not outlined in this Q&A (even though they might also impact on Direct and Indirect Participants of such German Trading Venues once the rules have entered into force).

For the Q&A we have taken into account views BaFin has expressed on a workshop on high-frequency trading held by BaFin on 30 April 2013 as well as publications by the BaFin. Please note that the Q&A reflects what we believe the current positions or interpretations of the HFT Act should be taking. However, at this stage, the content and requirements of the HFT Act remains unclear in various areas and BaFin’s view might not yet be final. BaFin will provide more guidance in the form of FAQs within the next few weeks. The FAQs will be available on the BaFin website: www.bafin.de.

This Q&A is for information purposes only and is not intended as proper legal advice. If you have any questions with regard to the HFT Act or if you need legal advice with regard to the HFT Act, do not hesitate to contact us.

Frank Herring
Partner
Tel +49 69 2648 5310
frank.herring@allenoverly.com

Dr Bernd Geier
Senior Associate
Tel +49 69 2648 5965
bernd.geier@allenoverly.com

Jens Moericke
Senior Associate
Tel +49 69 2648 5950
jens.moericke@allenoverly.com

Allen & Overy LLP

Bockenheimer Landstrasse 2, 60306 Frankfurt am Main, Deutschland

Tel. +49 69 2648 5000

Fax +49 69 2648 5800

www.allenoverly.com

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