

# ESMA Consultation Paper on the Algorithm Trading

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A Eurelectric response paper

March 2021

Eurelectric represents the interests of the electricity industry in Europe. Our work covers all major issues affecting our sector. Our members represent the electricity industry in over 30 European countries.

We cover the entire industry from electricity generation and markets to distribution networks and customer issues. We also have affiliates active on several other continents and business associates from a wide variety of sectors with a direct interest in the electricity industry.

## We stand for

The vision of the European power sector is to enable and sustain:

- A vibrant competitive European economy, reliably powered by clean, carbon-neutral energy
- A smart, energy efficient and truly sustainable society for all citizens of Europe

We are committed to lead a cost-effective energy transition by:

**investing** in clean power generation and transition-enabling solutions, to reduce emissions and actively pursue efforts to become carbon-neutral well before mid-century, taking into account different starting points and commercial availability of key transition technologies;

**transforming** the energy system to make it more responsive, resilient and efficient. This includes increased use of renewable energy, digitalisation, demand side response and reinforcement of grids so they can function as platforms and enablers for customers, cities and communities;

**accelerating** the energy transition in other economic sectors by offering competitive electricity as a transformation tool for transport, heating and industry;

**embedding** sustainability in all parts of our value chain and take measures to support the transformation of existing assets towards a zero carbon society;

**innovating** to discover the cutting-edge business models and develop the breakthrough technologies that are indispensable to allow our industry to lead this transition.

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# ESMA Consultation Paper on the Algorithmic Trading

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## EXECUTIVE SUMMARY

Eurelectric represents the interests of the electricity industry in Europe. Our work covers all major issues affecting our sector. Our members represent the electricity industry in over 30 European countries. We cover the entire industry from electricity generation and markets to distribution networks and customer issues. We also have affiliates active on several other continents and business associates from a wide variety of sectors with a direct interest in the electricity industry.

We welcome the publication of this Consultation Paper and its objective of having the current framework of algorithmic trading operate more efficiently.

We would like to stress there is a need to increase the proportionality criteria of algorithmic trading requirements. From our point of view, requirements should be based on the potential impact on the overall fair and orderly functioning of the market, which is linked to the nature, scale and complexity of the business of the firms carrying out these trades.

In our opinion, and as explained in the specific replies, it does not seem convenient to require the same number of obligations on all companies regardless of the nature, scale and complexity of their business.

The criteria to be considered by a company in its self-assessment, as referred to in article 9 of Commission Delegated Regulation 2017/589, could be used to directly or indirectly exempt several companies from some of the requirements. These criteria take into account the nature, scale and complexity of the business, such as - inter alia - the regulatory status of the firm, the number of algorithms and strategies running in parallel, the number of individual instruments, products, and asset classes traded, the monetary value of gross and net positions intraday and overnight, the nature of the strategies carried out. As an example, companies not applying high-frequency trading and applying algorithmic trading only to local venues could be excluded from the requirement of real time monitoring by the risk management function, the reconciliation of orders' logs or the necessity of the compliance function to have at all times contact with the staff that have access to the kill functionality.

**Q1: What is your overall assessment of the MiFID II framework for algorithmic trading, HFT and DEA?**

Eurelectric agrees that it is necessary and appropriate to properly regulate and control the use of algorithmic trading, HFT and DEA, because of the risks these technical solutions pose for the overall fair and orderly functioning of financial markets.

However, in our view, the current regulatory framework fails to adequately take into consideration the different levels of complexity and risk that can characterize different types of algorithms and trading strategies adopted, as well as the different levels of sophistication and different spectrum of purposes of legal entities engaged in such activity.

As said in the introduction, Eurelectric represents the electricity industry in Europe and the vast majority of its member companies are not investment firms.

It is noteworthy in this regard that the Commission Delegated Regulation (EU) 2017/589 and the rest of the regulatory framework for algorithmic trading always refers to “investment firms”. This happens despite the fact requirements for algorithmic trading are applicable both to investment and non-investment firms (due to MiFID article 1.5, which states: “Article 17(1) to (6) shall also apply to members or participants of regulated markets and MTFs who are not required to be authorised under this Directive pursuant to points a, (e), i and j of Article 2(1)”).

Eurelectric takes the opportunity of this Consultation to share the impression that the wording and the content of the Commission Delegated Regulation (EU) 2017/589 do not sufficiently take into consideration that non-investment firms are also required to comply with the very same requirements originally thought up, and foreseen, for investment firms. This is particularly critical given that non-investment firms inevitably have a less articulated internal organizational structure, and less mature systems and processes, as these primarily serve the business needs of their main activity (e.g. production and supply of power and gas) and are not subject to prudent regulation. Furthermore, non-financial firms use algorithmic trading inter alia for risk hedging and balancing sales and production portfolios.

In light of the above considerations, in our opinion the Commission Delegated Regulation (EU) 2017/589 should foresee a wider use of the proportionality principle to avoid overcharging firms - and especially non-financial entities - with excessive compliance costs.

It is worth mentioning that such an approach is already present in the regulation itself and that it already makes it possible for non-investment firms to use proportionality in the application of some specific requirements. However, the present references in CDR 2017/589 to the possibility of “having regard to the nature, scale and complexity of its business” is used occasionally on specific requirements (e.g., governance, stress testing, annual self-assessment). In our view, proportionality should instead be set as a general and fundamental principle - given the wide variety of entities engaged in algorithmic trading and of algorithms covered by the Regulation. This may be achieved by clearly stating in an initial article that firms subject to this regulation shall apply it with regard to the nature, scale and complexity of the algorithmic system they use and of their business model.

**Q12: Do you see merit in ESMA developing a template for notifications to NCAs under Articles 17(2) and 17(5) of MiFID II? If not, please justify your position.**

No, we do not. The notification process to the NCAs works sufficiently and using a template could potentially impose additional burdens to the process.

**Q13: Do you agree that it would be useful to clarify that notifications should be done ‘without undue delay’?**

No, we do not.

**Q15: What is your view on clarifying the definition of algorithmic trading? If you deem it beneficial to refine the definition and account for further types of algorithms or algorithmic trading strategies, please provide your suggestion as well as underlying rationale.**

Apart from any consideration about the necessity of better defining algorithmic trading strategies, we want to stress again the importance of envisaging an appropriate level of proportionality in the implementation of requirements on algorithmic trading, at least for non-investment firms.

In practice, for the less technically complex algorithms, on the condition that they pose limited or no risks to the orderly functioning of markets, non-financial entities should be allowed to not apply the most burdensome requirements. By way of example, non-financial firms often simply use algorithms that block their activity automatically every time they conclude a deal and require a manual intervention to be restarted, or algorithms with specific limitations which prevent excessive order flows. In similar cases, a non-financial entity should have the flexibility not to adopt the more complex and sophisticated requirements, like - for instance - the reconciliation of electronic trading logs of orders or the real-time monitoring by units different from the trading desks (risk management).

To this purpose, as already said, we think that an initial article should state that firms subject to Commission Delegated Regulation (EU) 2017/589 shall apply controls and processes adequately addressing the nature, scale and complexity of algorithmic trading

**Q16: Do you think there should be specific requirements for different type of algorithms or algorithmic trading strategies in RTS 6? Please explain**

Eurelectric shares ESMA concerns that it may be difficult to verify from the outside whether any algorithm would have a limited impact on the overall fair and orderly functioning of the market (paragraph 109). Yet, as explained above, we think that the overall level of proportionality should be increased when it comes to regulatory requirements concerning trading algorithms. This is due to the presence of NIFs and simple algorithms, in relation to which it is objectively evident that applying the entire set of rules would be disproportionate.

In order to strike the balance between these needs, we suggest that the current regulatory framework should be integrated with a general statement aimed at confirming the use of proportionality as general interpretation criteria for all the provisions established in the regulation.

**Q21: Do you agree with the changes proposed to the self-assessment of Article 9 of RTS 6?**

In relation to the changes proposed to the current version of the self-assessment, in our opinion, the annual self-assessment should remain an internal compliance document in which the company internally assesses their activities in algorithmic trading in the best possible way, including for the purposes of identifying possible gaps and setting a plan of remediation actions if needed.

In our view, and as stated by ESMA in paragraph 79 of the Consultation Paper, NCAs always have the possibility to require from a firm - on a regular or ad-hoc basis - specific information concerning the algorithm and the trading strategy adopted by the company, as well as about the compliance with regulatory requirements. However, this should be done as something different and completely separated from the legal entities' internal self-assessment process.

As such, the self-assessment should be provided to NCAs upon request, and it should be left to the discretion of NCAs to decide, while planning supervisory activities, when to request such self-assessments for review, taking into account e.g. the type and complexity of the algorithm or the number of algorithms deployed by the market participant (i.e. applying a proportional and risk-based approach). Indeed, the introduction of a general obligation to provide such self-assessment to NCAs for review would be burdensome for market participants, even if the self-assessment would have to be provided "only" every 2 years. We question whether such changes would increase the quality of such self-assessment.

We note in this respect that the current regulatory regime requires the risk management function to draw up a validation report (after having involved technical staff), that the compliance function shall be informed of any deficiencies identified in such report, and that the report shall be audited by the internal audit function and approved by senior management, which is why, in our view, it provides sufficient safeguards to ensure the quality of the self-assessment.

**Q24 : Do you agree with limiting the self-assessment to every two years and to require trading venues to share it with their relevant NCA?**

We refer to the answer to Q21.

**Q43: What do you think of ESMA proposals and suggested amendments to RTS 8? In your view, what other aspects of the market making regime require to be amended and how?**

Article 17(3) of MiFID generally calls for "an investment firm that engages in algorithmic trading to pursue a market making strategy" to enter into binding written agreements with the trading venue; article 1(5) MiFID extends the applicability of such market making agreements regime also to non-investment firms.

In this context, we would highly recommend to take due account of ESMA consideration in paragraph 310 of the Consultation ("the provisions in MiFID II and RTS 8 appear to have been designed for a specific type of market making, i.e. market making activity undertaken by algo or HFT traders trading through continuous order book"), and to more explicitly limit the application of RTS 8 and market making agreements: namely, general liquidity provision agreements among market participants and TVs (those that simply provide for a voluntary provision of liquidity to the market with a fee rebate as incentive) should not be required to enter into market making agreements.

Eurelectric pursues in all its activities the application of the following sustainable development values:

Economic Development

- Growth, added-value, efficiency

Environmental Leadership

- Commitment, innovation, pro-activeness

Social Responsibility

- Transparency, ethics, accountability



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