Implementing Germany's HFT Act

Balancing regulatory requirements and market practice

Miroslav Budimir, senior vice president, Deutsche Börse, explains how the exchange worked with clients and regulators to adapt to new rules on algorithmic and high-frequency trading.

As first movers in the European trading landscape, German regulators have responded to the widespread concern regarding the perceived risks of uncontrolled high-frequency trading with the HFT act, introducing new requirements for algorithmic and HFT firms active in German cash and derivatives markets. Having consistently stated the belief that algorithmic respectively high-frequency trading primarily adds to the market quality, Deutsche Börse has been making considerable efforts to warrant appropriate transition periods.

Anticipating MiFID

Even though the act only applies to the German market, Deutsche Börse is well aware of the importance of a successful introduction of all means to meet the regulator's requirements, since similar requirements are to be expected with the reviewed MiFID in 2017. It does not come as a surprise that European market operators and investors alike are watching the developments in German markets very closely. Deutsche Börse's goal has been to introduce the new rules, with its possible effects on trading activity and Xetra market quality always borne in mind. The following are the most important requirements of the German HFT act: licence requirements for high-frequency traders (being in effect since November 2013 respectively February 2014); the introduction of order-to-trade ratios (OTR) and excessive usage fees (ESU) (both being in effect since December 2013); and the flagging of algorithmically generated orders (coming into effect in April 2014). The latter is not limited to HFT firms but will apply to all direct Xetra participants.

Miroslav Budimir

As a first step, Deutsche Börse developed and introduced new mechanisms to track OTRs and system usage levels. Xetra participants receive regular reports on these parameters, thereby facilitating the monitoring of their trading activity. Participants were able to adjust their trading activity to avoid exceeding the given thresholds and incurring the resulting sanctions and fees: from December 2013, not a single member violated the OTR, which implies that the goals of the Act have been effectively addressed.

Additionally, Deutsche Börse started to work closely with the authorities to address a number of practical issues – especially regarding the requirement for all participants to flag algorithmically-generated orders – to support Xetra members in complying with the new rules.

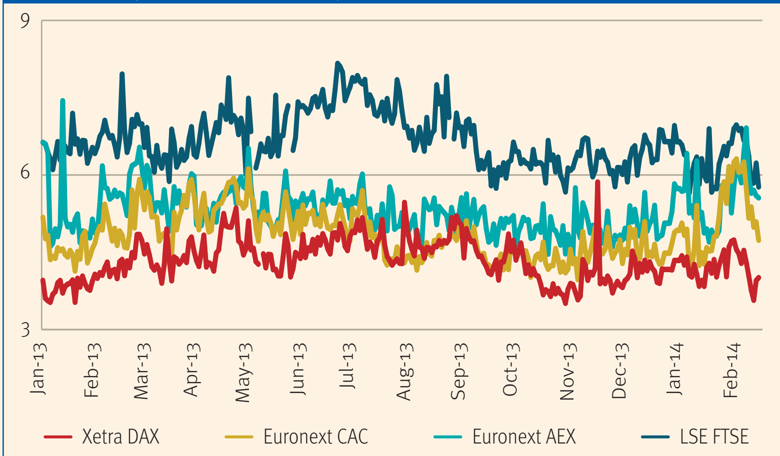
Regarding the licence requirement, there are 15 firms active on Xetra which meet the definition according to the HFT act.

Impact on Xetra

To evaluate possible effects of the HFT Act, a simple market quality measure can be utilised: the development of the average bid-ask spread of DAX index constituents on Xetra. For comparison purposes, the spread development of constituents of the CAC and AEX at Euronext and FTSE at LSEG had been included as well.

As can be seen from Figure 1, spreads are on average lowest for the DAX on Xetra. Shortly after the introduction of the HFT law on 15 May 2013, there was a slight increase in DAX spreads, compared to other indexes. This might have reflected an increase in uncertainty that prevailed in the market afterwards. However, this uncertainty levelled off during autumn 2013, as it became clear

FIGURE 1: SPREAD DEVELOPMENT FOR MAJOR HOME MARKETS (IN BASIS POINTS)



Source: Data provided by LiquidMetrix – LiquidMetrix WorkStation

> **"European market operators and investors alike are watching the developments in German markets very closely."**

that HFT firms would apply for a licence, and when Deutsche Börse presented the concepts for measuring OTR and ESU fees.

To get a more representative picture of the impact of the HFT Act on Xetra, more data of a longer period of time will have to be analysed. On the other hand, the result implies that the implementation of the HFT Act did not create shocks nor disturb trading activity in a significant way. All in all, the provisions of the Act are well suited to preventing potential risks from algorithmic and high frequency trading, without having a disruptive effect on the market. Behind this background, the lessons obtained could provide fruitful when designing MiFID's level II measures on this topic. ■

Further information on the HFT Act can be found at http://www.xetra.com/hft

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