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Enhanced Governance and Compliance Measures for Investment Firms Involved in Algorithmic Trading (governance)

Stakeholders such as investment firms, dea providers and clearing firms focused on algorithmic trading, are required to observe more stringent rules in the domains of governance, staffing, training and other organizational aspects. Firms, depending on their business' nature, scale, and complexity, have various governance structures in place, and compliance with the increasingly emphasized regulatory obligations is integral for algorithmic trading companies. The final draft rts underlines the governance process, the role of compliance staff and the necessity of developing and monitoring trading systems and algorithms suitable for each firm's specific business parameters. It also ushers in a formal requirement for firms to conduct annual self-assessment. The directive further clarifies the independence of the risk function, outlines the due diligence practices of dea providers, and stipulates stricter governance processes for outsourcing partners. A cost-benefit analysis reveals incremental obligations in areas such as organizational requirements, governance, compliance, staffing, and outsourcing.

Assessing the Impact of Automation and Transparency on Trading Venues (environment)

The primary interest in this text revolves around the adaptation of trading venues to a pre-trade transparent environment as per new draft Regulatory Technical Standards (RTS). This involves understanding the baseline, including legal aspects (Mifid I and II, EMIR, etc.) and market practices. Key concerns address the adjustment of prices by market and price makers due to potential opposition from the market or other price makers. There is anticipation about the potential impact on pre-trade transparency with the implementation of the LIS waiver under a double volume cap mechanism environment. The use of electronic trading could result in positive impacts for end-investors, such as tighter spreads and higher liquidity. The draft RTS brings stringent obligations regarding testing and deployment of trading algorithms and systems. The costs of compliance, particularly establishing a non-live environment, could be high and may be passed on to trading venues and their members. The proposed RTS aims to enhance the security of the trading environment and lessen the risk of disorderly markets by ensuring careful consideration of material changes.

Impact and Compliance Costs of New Trading Regulations on Different Business Models (business model)

The study gathers responses estimating compliance costs from various firms with different business models. Majority expect a negative impact on their business model due to the regulatory technical standards (RTS), with only a few anticipating positive changes. The RTS could also impact business activities outside the EU and may lead to increased trading costs, with the possibility of firms moving their trading outside EU. Compliance necessitates that trading venues maintain robust monitoring systems, the extent of which varies by venue and depends on their degree of automation. The proposed RTS would greatly affect investment firms whose business models could be altered by it. The impact of these regulations also extends to diverse stakeholders within the market. Lastly, the effect on trading venues would largely depend on their business models, target clients, and fee structures. Despite the potential of negative impacts, a few firms see a positive cumulative effect on their business model resulting from publication arrangements.

The Impact and Evolution of Technology in Financial Markets (technology)

The use of sophisticated and innovative technology in financial markets is driving a transformation, enabling synergies such as streamlined compliance and new approaches to data management. As trading technology evolves, voice business is expected to move towards electronification to meet transparency requirements. Market fragmentations are being addressed through greater connectivity via aggregators and sourcing engines. Furthermore, electronic trading platforms are facilitating transactions and creating space for new roles in market participation. There is also a notable trend towards low latency trading driven by a surge in transparency in non-equity instruments. This increase in the use of technology also highlights the potential risks, specifically around algorithmic and high frequency trading, calling for robust systems, procedures, and controls to mitigate these. Firms must be prepared for adaptation, including necessary technology upgrades to meet these challenges while enhancing their competitiveness. The rise in algorithmic trading also necessitates additional controls for software companies and vendors providing Direct Electronic Access (DEA) services. In an ever-competitive environment, technology adoption, cost efficiencies, and risk management play crucial roles for both new entrants and incumbents. The financial landscape has changed significantly over the past decade, largely driven by the impact and evolution of technology in trading, from data management to the emergence of high-frequency trading techniques.

Importance of Data Confidentiality and Integrity in Investment and Trading Activities (confidentiality)

The final draft RTS emphasizes the importance of ensuring data confidentiality and integrity in maintaining orderly markets. Clauses on audit rights, access to relevant technical documentation, and confidentiality arrangements are expected in agreements with third party providers/vendors. The report highlights certain regulatory articles that necessitate secure mechanisms that prevent unauthorized access and data corruption while maintaining data confidentiality. The main advantages of these secure systems are an increase in confidence in data integrity and the prevention of unauthorized access. Various implications are mentioned such as the impact on confidentiality agreements between trading venues and market participants, and the potential associated indirect effects on the volume of trading and type of venue used. The summary also discusses the associated costs for implementing and maintaining these measures. ESMA is empowered to develop draft RTSs that specify the conditions under which access is granted, including the confidentiality of information and the standards guiding how a benchmark may be proven to be new.

Benchmark Innovations and Impact on Financial Market Protocols (innovation)

The document discusses that new technologies and innovations can facilitate better precision and accuracy with respect to a reference time. As per the provisions of MiFIR Article, new benchmarks can be deferred for licensing for a specific period, provided that they're not mere adaptations of existing ones and they bring meaningful methodological differences. However, it raises concerns that open access requirements can make European trading venues less competitive globally due to the complexity of obligations and potential distraction from innovation and growth. It also highlights ESMA's role in identifying, monitoring, and assessing trends, potential risks and vulnerabilities in financial markets, including those linked to financial innovations. It emphasises the need for a coordinated approach to the regulatory and supervisory treatment of new and innovative financial activities. The document also calls for vigilance in ensuring that market practices and advances do not undermine innovation and the dynamic nature of financial markets.

Accountability and Regulation in Algorithmic Trading Systems and Exchange Contracts (accountability)

A systematic review of performance for algorithmic trading systems is a requisite under the ESMA guideline, focusing on the governance, accountability, and overall business continuity arrangements associated with these systems. Trading platform operators and CCP boards are mandated to assume full responsibility for risk management. Individual contracts, whether soft commodity futures, oil products, or agricultural products, follow a position accountability regime and certain position limits. If the set limits are exceeded, the reason for the position and any relevant contracts must be explained to the exchange. Regular monitoring of these limits is conducted considering multiple factors regarding the nature of the contract and its fundamentals. Organizations adopt different threshold reporting requirements based on accountability levels with all transactions requiring daily reporting. In turn, investment firms are expected to develop and monitor trading systems, establish clear lines of accountability, and segregate functionalities to efficiently track unauthorized trading activities. This organized approach aims to foster management accountability and robust control over internal systems.

Enhancing Transparency in Financial Recommendations through Conflict of Interest Disclosures (objectivity)

The text primarily discusses the need for increased transparency in investment recommendations, through stringent disclosure of conflicts of interest. It emphasizes on the importance of objectivity and guarding against existing relational or circumstantial impairments to maintain the reliability of financial advice. The enforcement of consistent disclosure norms addresses potential market influencers who can sway financial trends. The inclusion of these disclosures even in summarized recommendations is proposed, pointing to the web location where full disclosure information can be obtained. The text suggests stricter disclosure rules and reveals concerns about the proposed system potentially inhibiting normal investment communications. An emphasis is also placed on methodological standardization for assessing returns. The text comments on the pros and cons of using credit ratings, but underscores the necessity of objectivity in their deployment. Overall, the aim is to ensure a balanced and transparent financial advisory system that minimally affects investor relations while optimally revealing potential conflicts.

Risks Related To Fraud and Personal Data Theft in Financial Markets (fraud)

High frequency trading (HFT) might potentially exacerbate market volatility and enable fraudulent manipulation strategies. A more standardized identification of clients could help in monitoring and detecting fraudulent activities across multiple markets. There are concerns about increased risk of personal data fraud and identity theft due to the complexity of reports. Identifying the exact date when inside information originated could be challenging if it involves

illicit acts like serious employee fraud.
Data reporting service providers must include relevant personal and professional information of each member of their management body during authorization. This information should prove the member's expertise and credibility. Legal and professional sanctions related to fraud, embezzlement, or misconduct in business management will be considered while granting authorization.
There are foreseeable issues related to the legal framework of asset management and custody, such as the possibility of self-custody and flexible segregation rules, which might elevate the risk of significant loss and fraud, hence lowering investor protection. Under US regulation, failures in marketing activities and dealings with clients, as well as violations of anti-fraud provisions, are liable to penalties.
There is a unanimous agreement that fraudulent behavior is unacceptable, though it might not essentially constitute market abuse. Compliance risk, internal or external fraud, data accuracy, inadequate accounting practices, financial crime and fraud and operational processing errors are also potential risks in this sector. ESMA is also working on implementing an anti-fraud strategy to enhance its fraud detection abilities.
There are concerns that flaws in automated financial advice tools could result in reputational risk for the institution, which could affect its overall market confidence. Moreover, credit rating agencies are urged to promptly report any potential infringement that could risk the integrity and objectivity of credit ratings.

Compliance with International Standards in the Financial Sector (international standards)

The text discusses detailed efforts to maintain uniformity and precision in clock synchronization across the European Economic Area (EEA), in line with the MiFID II article. Regulatory Technical Standards (RTS) are proposed to specify the level of accuracy needed for such synchronization. Feedback has been received from different industry representatives. Further, the text emphasizes the commitment of jurisdictions like Jersey and Guernsey to meet the AIFMD standards to counter money laundering and terrorist financing in line with FATF. Their commitment extends to maintaining effective tax information exchange practices as per OECD standards. In relation with Hong Kong, it's mentioned that the regulatory regime for funds and managers is of international standards. Lastly, in Switzerland, regulations were revised to close gaps and align with changing international norms, particularly the AIFMD. The thrust is towards increased investor protection and fulfilling prerequisites for asset managers, setting thresholds and maintaining risk management groups in line with global norms.

Prudential Models and Their Implication on Investment Firm Stability (going concern)

Current standards aim to enhance the stability of investment firms on a 'going concern' basis, considering their ongoing financial health. The large exposure risk for these firms may vary depending on the 'going concern' or 'gone concern' prudential model application. If both investor and investee experience losses, the capital might not be sufficient to maintain them on a 'going concern' basis. Certain firms, which pose no systemic risk to financial stability, could be exempted from a fixed (conservation) buffer, decreasing the need for 'going concern' recovery. Regular risk-based requirements coupled with winddown analysis are considered effective in handling the firm as a 'going concern' while safeguarding its 'resolution' aspect. Clear guidelines cover areas like mapping the financial conglomerate structure, supervisory coordination, and assessment of financial conglomerates on 'going concern' and in emergencies.

Addressing Conflict of Interests: ESMA's Ethics Approach and Aggregation Debate (ethics)

The current debate revolves around several concerns raised against the aggregation of producer's positions. Critics argue that it could distort or muddle the producer's real stance, clash with standard employment law principles, and is futile as investment recommendations should already be free from conflicts of interest, given the existing code(s) of ethics/conduct. The European Securities and Markets Authority (ESMA) has robust internal control standards and a strong focus on upholding ethics and conflict of interest management. It has established the roles of an ethics officer and a deputy to promptly address ethical concerns and foster a culture of integrity within the organization. A guidebook exists to serve as a guideline for all associated staff.

ESMA plans to implement its conflict of interest policy for non-staff in Q4. However, while there is widespread agreement on these measures, some respondents underscore the need for a greater emphasis on ethics, suggesting that every investment firm should individually adopt a code of ethics. But ESMA refutes this, stressing that firms should ensure that their staff is knowledgeable and capable of meeting regulatory and legal requirements and business ethics standards. The agency does not view the adoption of individual ethical codes as a specific requirement.

Assessing the Effectiveness of Internal Controls and Risk Management Systems in Investment Companies and IAs (internal controls)

The FSAP report indicates that the grading on implementation falls short due to inadequate examination coverage in IAs and investment companies. This also includes insufficient eligibility requirements, especially for CPO and IAs, concerning risk management and internal controls. To improve the situation, ESMA aims to conclude ongoing investigations into ratings process and IT security, which could potentially impact the quality of ratings. ESMA is seeking to enhance its supervisory effectiveness by clarifying terminologies used and building relationships with Independent Non-Executive Directors (INEDS). The reported anomalies in the risk management process and internal controls in CRAs can be rectified by aligning with internationally used frameworks and best practices. However, ESMA's supervision can be further enhanced by defining key terms used in regulations, which includes the role of internal controls. Aligning these controls with a standard risk framework, proportional to the size and complexity of a CRA's operation, will help especially in managing operational risks. There is also an emphasis on the impact of acquisitions on corporate governance reflecting in departmental compositions, administrative procedures, internal controls, IT architecture, outsourcing policies, and shareholder voting rights.

Impact of Non-Written Recommendations on Current Market Practices (interviews)

Non-written recommendations, which occur through various mediums such as meetings, road shows, and audio/video conferences are a critical area of focus. It's advisable that those involved in these processes be granted the liberty to tweak their presentation methods and disclose interests or conflicts of interest keeping this regulation in mind. However, for balanced recommendations, additional disclosures may be necessary but the presentation style or length could make this difficult. To tackle this, these information disclosures can be externally placed where recipients can access them freely. The data for these findings were collected using a combination of interviews and questionnaire responses, forming a comprehensive stakeholder survey. Several stakeholders expressed concerns regarding these practices, implying a greater impact on current market practices than initially anticipated. This impact is believed to exist without deriving significant benefits for market participants or other entities.
