

Germany Adopts New Prudential Rules for High-Frequency Trading

On May 15, 2013, the German Act on the Prevention of Risks Related to, and the Abuse of, High-Frequency Trading (*Gesetz zur Vermeidung von Gefahren und Missbräuchen im Hochfrequenzhandel*, the „Act“) entered into force. The Act preempts in part a regulation of algorithmic trading that has been proposed on the European Union level in connection with the revision of the European Markets in Financial Instruments Directive (“**MiFID II**”). In particular, the Act introduces new prudential requirements for proprietary trading firms engaging directly or indirectly in high-frequency trading (“**HFT Firms**”) on organized markets or multilateral trading facilities in Germany. Subject to certain transition periods, such HFT Firms must obtain a license for financial trading institutions (*Finanzdienstleistungsinstitute*) and comply with the minimum capital and organizational requirements for financial trading institutions set forth in the German Banking Act (*Kreditwesengesetz*). The Act also requires exchanges and other trading venues in Germany to implement prudential limitations on high-frequency trading, and to comply with certain organizational requirements.

In this Memorandum, we provide an overview of the high-frequency trading activities subject to regulation (under A.) and the licensing requirements for HFT Firms under the Act (under B.).

A. Forms of High-Frequency Trading Subject to Regulation

1. Statutory Definition

High-frequency trading within the meaning of the Act comprises proprietary trading in financial instruments (regardless of whether or not such trades constitute a service for third parties) by using a “high-frequency algorithmic trading technique”. Pursuant to the Act, a high-frequency algorithmic trading technique is characterized by:

- the use of infrastructure intending to minimize latency times,
- automated decisions on the initiation, generation, routing and execution of orders without human intervention regarding individual trades or orders, and
- high intraday message rates in the form of orders, quotes and/or cancellations.

The elements of this definition correspond largely with the MiFID II proposals that are currently being discussed on the European Union level. However, neither the legislative materials related to the Act nor the current MiFID II proposals provide more specific guidance on the interpretation of the various indefinite legal terms used in the definition. Market participants engaging in algorithmic trading thus face uncertainty as to whether they are subject to the new prudential requirements for high-frequency trading.

2. *Initial BaFin Guidance*

To a large extent, the regulatory framework for HFT Firms will be shaped by the practice of the Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht*, “**BaFin**”), which is the competent authority for the licensing and supervision of HFT Firms under the Act. The BaFin has published initial guidance on its interpretation of the Act.¹ With regard to the definition of “high-frequency algorithmic trading technique”, it is the current position of the BaFin that:

- “infrastructure intending to minimize latency times” comprises, for example, the use of co-location or proximity hosting services, high-speed electronic access and the use of a data connection to the matching machine of the market with the largest bandwidth offered (currently 10 Gbit/s), and
- a “high intraday message rate” equals an annual average of 75,000 messages per trading day.

The BaFin has not yet completed its review of the Act, and it continues to explore the technical details of high-frequency trading, taking into account the feedback that it receives from market participants. It is therefore conceivable that the BaFin may change its current position based on such feedback, or apply additional criteria to further specify the elements of a “high-frequency algorithmic trading technique”.

B. *Licensing Requirements for HFT Firms*

1. *German HFT Firms*

Under the Act, high-frequency trading on organized markets or multilateral trading facilities in Germany constitutes a regulated activity. Therefore, German HFT Firms that are not yet licensed as a bank or financial trading institution and engage in high-frequency trading activities as described above will generally be required to obtain a license as financial trading institutions under the German Banking Act. This licensing requirement applies not only to HFT Firms that are members of a German trading venue, but also to HFT

¹ http://www.bafin.de/SharedDocs/Veroeffentlichungen/EN/Meldung/2013/meldung_130322_hft-gesetz_en.html with links to further BaFin publications on the Act.

Firms that get direct electronic access to a German trading venue through a direct or indirect member of such venue. HFT Firms that apply for a license within six months after publication of the Act (*i.e.*, until November 14, 2013) are deemed to be provisionally licensed until the BaFin issues the license or denies such application.

2. *HFT Firms Domiciled in the European Economic Area*

In principle, foreign HFT Firms are also required to obtain a German license for financial trading institutions if they engage in high-frequency trading on a German trading venue through a German branch or on a cross-border basis.

A German license is not required, however, if another member state of the European Economic Area (“**EEA**”) has licensed the HFT Firm to engage in proprietary trading, and the HFT Firm notifies the BaFin through its home state regulator that it intends to engage in high-frequency trading under the foreign license (i) on a cross-border basis, or (ii) through a German branch office (so-called “European passport”). In this context, the BaFin has stated that a computer server may be considered a branch for the purposes of the Act, without specifying further what regulatory implications such qualification as a branch may have for the HFT Firm concerned (*e.g.*, whether such branch would have to maintain personnel in Germany which may in turn trigger adverse tax consequences). HFT Firms domiciled in another EEA country that submit the notification to their home state regulator within six months after publication of the Act (*i.e.*, until November 14, 2013) are deemed to be provisionally licensed until the completion of the notification procedure.

The BaFin has also indicated that HFT Firms domiciled in the EEA may obtain an exemption from the licensing requirement if the BaFin concludes that the respective HFT Firms “do not require supervision, given the particular nature of their business” and certain additional requirements are met.² However, such an exemption would only be granted on a case-by-case basis, and only if, under the particular circumstances of the individual case, a cross-border activity of an HFT Firm in Germany would not raise any concerns as to proper supervision.

3. *HFT Firms Domiciled outside the European Economic Area*

Neither the “European passport” nor the exemption described under B.2. are available to HFT Firms domiciled outside the EEA. In order to continue their high-frequency trading activities on German trading venues, such HFT Firms will generally have to (i) establish a subsidiary or branch office in Germany and obtain a German license, or (ii) establish a subsidiary or branch office in another member state of the EEA, obtain a license from the competent regulator of such EEA state, and use this license to “passport” their

² http://www.bafin.de/SharedDocs/Downloads/EN/Veranstaltung/dl_130430_hft_top2.pdf?__blob=publicationFile, page 17 *et seq.* with reference to Section 2(4) of the German Banking Act. For guidance on this exemption see also http://www.bafin.de/SharedDocs/Veroeffentlichungen/EN/Merkblatt/mb_050400_crossborder_en.html.

high-frequency trading activities into Germany. HFT Firms domiciled outside the EEA are deemed to be provisionally licensed until the issuance or denial of the license (in case they apply for a German license), or until the completion of the notification procedure (in case they submit the “passport” notification), as the case may be, provided that the license application or submission of the passport notification is made within nine months after publication of the Act (*i.e.*, until February 14, 2014).

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If you have any questions in regard to the issues addressed herein or the Act in general, please do not hesitate to contact [Dr. Gabriele Apfelbacher](#), [Dr. Peter Polke](#), or [Dr. Alexander Rahn](#) at the Frankfurt office of Cleary Gottlieb or any of our partners and counsel listed under “Germany”, “Lawyers in this Practice”, under the “Practices” section of our website at <http://www.clearygottlieb.com>.

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