Editorial

Challenges for Legislators and Supervisors Ahead

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Due to the soaring use of IT in the financial industry, financial transactions become faster and increase in quantity. Simultaneously, hardware and software problems at trading participants and platforms have stimulated a public debate on security, transparency, integrity and volatility of financial markets. The guidelines for IT regulation in the financial sector however remain controversial, e.g., in the MiFID II discussion on latency for high frequency trading (HFT). The task ahead for legislators and supervisors in IT regulation shall be differentiated into the following four aspects:

Technical progress and regulatory development lead to an increasing supervisory focus on IT stability and permanent adaption of stability-providing regulations. With OTC derivatives clearing being transferred on the basis of EMIR regulation to clearing houses in 2014, the IT system stability of clearing services providers will become a question of systemic importance. To safeguard IT stability of market places, the German High Frequency Trading Act of 2013 (HFTA) pledges exchanges and MTFs to adopt maximum order-to-trade ratios and excessive usage fees, striving to limit the influence of HFT. This corresponds to the ESMA 2012 „Guidelines on systems and controls in an automated trading environment", which call for instruments against capacity limit breaches and excessive flooding of order books.

Second, supervisory authorities will have to continuously adapt their instruments to be able to effectively execute micro-prudential supervision. ESMA guidelines require high technical standards for market places, such as close to real-time monitoring to be able to react to new trading strategies. The HFTA provides BaFin, the Trading Surveillance Offices and the Exchange Supervisory Authorities with reshaped instruments. Trading participants will be obliged to flag their orders generated through algorithmic trading to identify algorithms more quickly in order to react on peculiar trading behavior. Maximum order-to-trade ratios will contribute to strengthen trading platforms' resilience against impairments of market integrity. Moreover the Act requires appropriate measures, e.g., volatility interruptions, to ensure an orderly determination of prices also in case of significant price fluctuations.

Third, the intensified use of IT implies legal and normative consequences. The capital supplying function of market places must not be reduced by electronic trading-induced changes of the market structure. Due to the principle of equal opportunity, all trading participants must potentially be able to have access to the latest IT developments. More specifically, the applicability of market rules to all trading activities should be ensured. ESMA guidelines provide for the sole responsibility of the direct access provider. However, direct electronic access via order routing should constitute effective legal responsibility in order to prevent loopholes also because of the increasing number of order routing clients.

Finally, the increasing use of electronic systems in the financial industry creates macroprudential challenges: Financial entities worldwide use different identification codes which created difficulties in identifying financial market actors during the critical stage of the 2008 crisis. Therefore, the G-20 and the Financial Stability Board in 2012 initiated the "Legal Entity Identifier" project (LEI) which aims at developing a central register for financial market institutions and activities. The newly founded Regulatory Oversight Committee is now about to set up the foundation and operating unit of this project.

The aforementioned challenges can technically and legally be met. The central challenge for the needed regulation is politics. Resistance to the required regulations originates from well-known sources: international competition of financial centers, their political supporters and the industry itself. Therefore, the task for legislators and supervisors ahead comprises not merely the aforementioned IT-induced challenges but political challenges to realize regulation on an "European level playing field" to forge ahead in making financial markets more safe.