LATHAM&WATKINS

Client Alert Commentary

Latham & Watkins Financial Regulatory Practice

27 February 2018 | Number 2283

FCA Sets Expectations on Algorithmic Trading

The FCA has published a report, clarifying its expectations of firms that develop or use algorithmic trading strategies.

On 12 February 2018, the FCA published a report on algorithmic trading compliance in wholesale markets. Although the report largely focuses on the practices of larger firms that develop algorithms themselves, it is relevant to all firms that develop and/or use algorithmic trading strategies.

When firms were implementing the MiFID II algorithmic trading obligations under RTS 6, many questions were raised as to the scope of the obligations and how far the regulators expected firms to go — particularly in relation to the role of compliance, the kill functionality, and the post-trade controls required for risk management. The FCA report, therefore, should provide the industry with much-needed clarity as to their obligations, even if some of the FCA's observations may go a bit further in some areas than many firms would like.

The FCA has identified five key areas of focus, and outlined some useful examples of what it considers to be good and poor practice in relation to each of these areas. We highlight below our thoughts on some of the key examples. The FCA states that it will continue to assess whether firms have taken sufficient steps to reduce risks arising from algorithmic trading, and that this will continue to be a primary concern for the regulator. Therefore, firms should pay close attention to the FCA's expectations.

Defining algorithmic trading

FCA expectation: Firms must establish an appropriate process to identify algorithmic trading, manage material changes, and maintain a comprehensive inventory of algorithmic trading across the business.

Good Practice:

- Firms who conduct extensive reviews (consulting all aspects of the business) to consider at length how trading algorithms are used within the firm. These firms are able to develop appropriate definitions and ensure relevant activities across the whole business are captured. Many firms will struggle to say that they do this so comprehensively, or that they truly consider the use of algorithms across the whole business. Firms need to think carefully about activities in all areas of the business, not just areas in which algorithms are widely used.

Poor Practice:

- Firms who don't have clearly defined inventories in place and are only able to provide generic high-level descriptions for their algorithms, strategies and systems. Firms need to have detailed descriptions in place, particularly as these descriptions are something the FCA might wish to inspect as part of its focus on algorithmic trading. So, firms should assume the FCA can understand the magic in the detail of an algorithm.

Development and testing

FCA expectation: Firms must maintain robust, consistent and well understood development and testing processes that identify potential issues across trading algorithms before full deployment.

Good Practice:

- Firms who have checkpoints throughout the development and testing process (for example, after initial due-diligence was completed, at several stages during testing and prior to full deployment) with a full review at the end of each stage. This includes:
  - An independent committee to check all the relevant documentation, ensure all testing procedures have been completed satisfactorily and verify that the algorithm is consistent with the original specifications
  - Active representatives on the committee from Risk, Compliance, Legal, Business, Technology, Finance and Operations
  - A dedicated software development team to provide independent verification before moving to the next stage

This is only really relevant to, and feasible for, larger firms with extensive algorithmic trading activities.

Poor Practice:

- Firms who are unable to provide effective MI to senior management on areas such as conformance testing, operational arrangements, pre-trade risk parameters, training and surveillance procedures prior to deployment. This is important not only for the firm, but also for senior management to document that they have provided appropriate oversight and, if necessary, challenge.

Risk controls

FCA expectation: Firms must develop suitable and robust pre-trade and post-trade controls to monitor, identify and reduce potential trading risks across algorithmic trading activity.

Good Practice:

- Firms who maintain detailed controls at multiple levels. For example, by client and/or trading strategy depending on the type of business undertaken, as well as on a firm wide basis. These control settings are reviewed on a regular basis to ensure they remain appropriate. The FCA clearly is expecting a structured and sophisticated approach to risk controls; basic controls or arrangements that have not been tailored to the firm's activities will not be appropriate.

Poor Practice:

- Firms who do not formally log incidents/breaches and fail to provide MI reports to appropriate forums. This prevents valuable MI being presented for senior management to identify potential emerging issues and risks. Firms need to consider how they detect concerning patterns over time, as well as individual incidents.

Governance and oversight

FCA expectation: Firms must maintain an appropriate governance and oversight framework that demonstrates effective challenge from senior management, risk management and compliance.

Good Practice:

- Firms where algorithmic trading is fully understood by senior management, who play a key role in providing challenge across the business. For example, where senior management are involved throughout the development and testing process and actively seek to understand the potential market conduct implications. This is particularly noteworthy as the FCA is not only expecting senior management to take full responsibility for overseeing algorithmic trading activities, but for actually understanding the trading taking place. Senior managers who consider it appropriate to "leave it to the experts" should take note.

Poor Practice:

- Compliance functions who are unable to demonstrate that compliance staff have sufficient technical knowledge to oversee and monitor algorithmic trading activity effectively. Firms need to ensure that relevant staff receive appropriate training and have the right skills. Firms should also ensure that compliance staff understand not only algorithmic trading activity in general, but also the particular activities of the firm.

Market conduct

FCA expectation: Firms must consider the potential impact of their algorithmic trading on market integrity, monitor for potential conduct issues and reduce market abuse risks.

Good Practice:

- Firms who consider how they can tailor their monitoring and surveillance systems to specific risks within their algorithmic trading activity and also ensure suitable market abuse training is conducted for all relevant members of staff. As demonstrated by a recent market abuse systems and controls enforcement case, the FCA expects firms to have tailored systems in place, reflective of the specific risks faced by the firm.

Poor Practice:

- Firms who maintain basic market abuse alerts such as insider dealing or layering and spoofing but do not consider other types of market manipulation which can be associated with algorithmic trading. For example, momentum ignition, quote stuffing and reference price gaming. Given the potential heightened risk of abuse, firms need to consider carefully the sorts of abusive behaviours that might occur, and keep abreast of any trends or developments.

If you have questions about this *Client Alert*, please contact one of the authors listed below or the Latham lawyer with whom you normally consult:

Rob Moulton
rob.moulton@lw.com
+44.20.7710.4523
London

David Berman
david.berman@lw.com
+44.20.7710.3080
London

Nicola Higgs
nicola.higgs@lw.com
+44.20.7710.1154
London

Brett Carr
brett.carr@lw.com
+44.020.7710.4695
London

Charlotte Collins
charlotte.collins@lw.com
+44.20.7710.1804
London

Becky Critchley
becky.critchley@lw.com
+44.20.7710.4519
London

Stuart Davis
stuart.davis@lw.com
+44.20.7710.1821
London

Ella McGinn
ella.mcginn@lw.com
+44.20.7710.4649
London

Frida Montenius
frida.montenius@lw.com
+44.20.7710.1161
London

Jonathan Ritson-Candler
jonathan.ritson-candler@lw.com
+44.20.7710.1815
London

Katy Sanders
katy.sanders@lw.com
+44.020.7710.4548
London

Emily Torrens
emily.torrens@lw.com
+44.20.7710.1883
London

You Might Also Be Interested In

What Next for Distributed Ledger Technology?

FCA Confirms Reform to the UK IPO Process

MiFID II Research Unbundling — Crisis Averted?

Latest Views From the FCA on Market Abuse