

Policy Statement | PS29/16

# MiFID II: Response to CP9/16

October 2016



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PRUDENTIAL REGULATION  
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This policy statement provides final rules and feedback on responses received to Consultation Paper 9/16 'Implementation of MiFID II: Part 1'.

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## 1 Overview

1.1 This Prudential Regulation Authority (PRA) policy statement (PS) provides feedback to responses to Consultation Paper (CP) 9/16 'Implementation of MiFID II: Part 1'.<sup>1</sup>

1.2 It sets out final rules to transpose the Markets in Financial Instruments Directive (MiFID II) legislative package<sup>2</sup> for:

- the extension of scope and harmonisation of the MiFID passporting regime in the Passporting Part of the PRA Rulebook; and
- systems and controls for firms who undertake algorithmic trading and provide direct electronic access to trade venues in the new Algorithmic Trading Part of the PRA Rulebook.

1.3 This PS is relevant to banks, building societies, PRA-designated investment firms and their qualifying parent undertakings, which for this purpose comprise financial holding companies and mixed financial holding companies, as well as credit institutions, investment firms and financial institutions that are subsidiaries of these firms.

1.4 The PRA is required by the Financial Services and Markets Act 2000 (FSMA) to publish a statement on the impact of rules on mutuals where the final rule differs from the draft of the proposed rule. In the PRA's opinion, the impact of the rules as made is not significantly different from the impact of the proposed rules on mutuals or other deposit-takers.

1.5 The PRA is also required by FSMA to publish a cost benefit analysis of any changes to the consultation proposals which the PRA considers to be significant. In the PRA's opinion, the changes to the consultation proposals are not significant, and do not warrant additional cost benefit analysis.

1.6 The policy contained in this PS has been designed in the context of the current UK and EU regulatory framework. The PRA will keep the policy under review to assess whether any changes would be required due to changes in the UK regulatory framework, including those arising once any new arrangements with the European Union (EU) take effect.

### **Future EU directly applicable Regulatory Technical Standards (RTS)**

1.7 The European Securities and Markets Authority (ESMA) has consulted on draft RTS and implementing technical standards relating to both passporting and algorithmic trading under MiFID II. The draft regulatory technical standards relevant to the rules in this policy statement have been adopted by the European Commission (EC).<sup>3</sup>

1.8 Subject to there being no substantial change to the text of the standards published in the Official Journal of the European Union which would result in substantive changes to the rules, the PRA shall insert the instrument numbers and commence the rules in the appendices to this policy statement. This policy statement will be updated at that point with the finalised instruments. Where necessary, the PRA may also make further changes to the rules without further consultation to give effect to the text of the final standards adopted by the EC.

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1 March 2016: [www.bankofengland.co.uk/pr/Pages/publications/cp/2016/cp916.aspx](http://www.bankofengland.co.uk/pr/Pages/publications/cp/2016/cp916.aspx).

2 Comprising the Directive, MiFID II (2014/65/EU), and the Markets in Financial Instruments Regulation (2014/600/EU) (MiFIR).

3 Updated rules for markets in financial instruments: MiFID : [http://ec.europa.eu/finance/securities/isd/mifid2/index\\_en.htm](http://ec.europa.eu/finance/securities/isd/mifid2/index_en.htm).

## 2 Feedback to responses to CP9/16

2.1 The PRA is required by FSMA to have regard to any representations made to the proposals in a consultation, to publish an account, in general terms, of those representations and its response to them, and to publish details of any significant differences in the rules as made.

2.2 Overall, the PRA does not consider that the responses received to the CP necessitate significant changes to its proposals. The PRA has, however, had regard to responses to the CP, and made amendments to the proposed rules where appropriate, including to add further clarity. The PRA sets out below the most important issues raised by respondents and notes the main areas where the PRA has made amendments to the rules proposed in the CP.

### Passporting

2.3 The PRA received no responses to the changes proposed to the passporting regime. The final rules are unchanged from the CP apart from minor clarifying amendments to align the rules better to the Directive. A definition of 'tied agent' has been added. The rules are set out in Appendix 1.

### Algorithmic trading

2.4 The PRA received two responses to the CP chapter on algorithmic trading. Respondents were supportive of the PRA's approach, and recognised the need for the PRA to make rules for algorithmic trading. The concerns raised by the respondents were mainly related to the scope of the proposed rules and record keeping requirements for firms engaged in high frequency algorithmic trading. Respondents sought clarifications about the activities and the firms covered by the rules, and details of the record keeping requirements.

2.5 The responses to the CP have been grouped in the sections below as follows:

- scope of the proposed rules;
- record keeping requirements on firms engaging in algorithmic trading; and
- requirements on firms providing direct electronic access (DEA).

### Scope of the proposed rules

2.6 Respondents to the CP requested clarification about why the proposed rules on algorithmic trading apply when a PRA regulated entity trades on a market outside the (European Economic Area) EEA that would have been deemed a regulated market, multilateral trading facility, or organised trading facility if it were set up in the EEA.

2.7 The PRA rules on algorithmic trading are motivated by prudential concerns. The PRA's prudential remit covers all activity undertaken by regulated firms that have prudential implications, whether in the United Kingdom or abroad. As a result, algorithmic trading activity on markets outside the EEA that would have been in scope of the rules had it been located within the EEA, is covered by the proposed rules.

2.8 Respondents also wanted clarification on which firms are in scope of the PRA rules. The scope of the PRA rules is narrower than that of the corresponding proposed Financial Conduct Authority rules.<sup>1</sup> This reflects the narrower scope of the PRA's rule making powers, which only cover a subset of firms within the scope of MIFID II. The PRA rules cover only 'CRR firms'. Broadly speaking, this only covers UK based banks, building societies and PRA-designated investment firms.

2.9 The PRA intends to maintain the scope of the algorithmic trading rules as set out in the CP. It intends to consult in due course on algorithmic trading rules in relation to the UK branches of third country PRA-authorized firms.

### **Record keeping requirements on firms engaging in algorithmic trading**

2.10 Respondents raised a number of points concerning the PRA's proposals in relation to record keeping requirements. These are addressed below.

#### **High frequency algorithmic trading**

2.11 The CP proposed detailed record keeping requirements on firms that engage in high frequency algorithmic trading. Several respondents noted, however, that when a firm has been identified as engaging in high frequency algorithmic trading, the rules are not clear on whether the record keeping requirements apply to the high frequency algorithmic trading activity, all algorithmic trading, or to the entire trading activity of the firm.

2.12 Additionally, respondents noted that the requirement to maintain records of all quotes should be restricted to 'firm' quotes only. This refers to quoted prices that can be acted on by other market participants ie another market participant can sell at the quoted bid price, or can buy at the quoted offer price.

2.13 In considering these points, the PRA has concluded it is not necessary for prudential purposes for it to require the maintenance of these records in parallel to the corresponding FCA requirements. It has therefore decided to remove these requirements from the proposed rules.

#### **System tests**

2.14 Having further considered the proposed rules, the PRA has concluded it is appropriate to provide greater granularity of the records that should be maintained of testing firms' systems. The CP stated a high level requirement for the firm to maintain a record of the "details of the testing of the firm's systems". This requirement is now broken down into two rules - Algorithmic Trading 2.3(4) for the methodological aspects of the test performed, and 2.3(5) for the results of, conclusions drawn from, and reactions to the tests.

2.15 The PRA concluded that this increased granularity of record keeping requirements for systems tests is within the PRA's discretion in transposing the Directive, does not impose additional burden on firms as it simply provides more clarity on what was required by the original more high level proposal, and ensures firms will be in a position to provide information that is useful for prudential purposes. The revised rules will enable firms to provide the PRA with information relevant to all aspects of their systems, including operational concerns such as the integration of the algorithmic trading systems with the rest of their systems, and the

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1 December 2015, Financial Conduct Authority, CP15/43, 'Markets in Financial Instruments Directive II Implementation': [www.fca.org.uk/publications/consultation-papers/cp15-43-markets-financial-instruments-directive-ii-implementation-%E2%80%9393](http://www.fca.org.uk/publications/consultation-papers/cp15-43-markets-financial-instruments-directive-ii-implementation-%E2%80%9393).



degree of management involvement in the design and operation of the algorithmic trading activity.

#### Records of any relevant information

2.16 MIFID II states that national competent authorities may, at their discretion, ask for any information that is relevant to a firm's algorithmic trading activity.<sup>1</sup> The Directive does not provide a detailed list of this relevant information.

2.17 Respondents to the CP pointed out that this was an unclear and potentially burdensome requirement on firms, which would be difficult to satisfy.

2.18 The PRA has noted this and will consult separately on what constitutes 'further relevant information' for these purposes. This further consultation will be intended to inform the PRA's expectations on algorithmic trading which would take effect with the entry into force of MIFID II.

#### Direct electronic access

2.19 The Directive requires firms that provide DEA to trading venues to their clients to have in place robust systems and controls.<sup>2</sup> In particular, systems and controls are needed to prevent client activity from creating risks to the firm. Respondents to the CP, however, pointed out that as firms providing DEA they can, at best, establish systems and controls that seek to prevent such an impact, but they cannot ensure its prevention.

2.20 The PRA notes this point and has amended Algorithmic Trading 2.4(3) to more closely align with the wording of Article 17(5) of MIFID II, by referring to 'appropriate' systems and controls.

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1 Article 17(2) of MiFID II.

2 Article 17(5) of MiFID II.

## Appendices

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- 1 PRA RULEBOOK: CRR FIRMS: PASSPORTING INSTRUMENT 2016**  
available at:  
[www.bankofengland.co.uk/pr/Pages/publications/ps/2016/ps2916.aspx](http://www.bankofengland.co.uk/pr/Pages/publications/ps/2016/ps2916.aspx)

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  - 2 PRA RULEBOOK: CRR FIRMS: ALGORITHMIC TRADING INSTRUMENT 2016**  
available at:  
[www.bankofengland.co.uk/pr/Pages/publications/ps/2016/ps2916.aspx](http://www.bankofengland.co.uk/pr/Pages/publications/ps/2016/ps2916.aspx)
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