Application of German High Frequency Trading Act to non-EU Investment Funds

The German High Frequency Trading Act (the "HFTA") entered into force on 15 May 2013. Pursuant to the HFTA, persons engaged in "high frequency trading" are subject to an authorization requirement in Germany. In addition, the HFTA introduces organizational requirements for entities engaged in algorithmic trading. BaFin and the stock exchange supervisory authorities are granted certain information rights. Trading participants have to comply with new rules, including appropriate order-to-trade ratios, order flagging and specific market manipulation prohibitions. Finally, new regulatory obligations have been introduced for trading venues, including a regulatory obligation to charge fees for excessive usage, to take suitable precautionary measures and to determine appropriate minimum tick sizes.

High frequency trading is defined in the HFTA to mean "the sale or purchase of financial instruments on own account as a direct or indirect member of a domestic organized market or multi-trading facility using a high frequency algorithmic trading technique which is characterized by (i) the use of infrastructures intending to minimize latency times, (ii) system determination of order initiation, generating, routing or execution without human intervention for individual trades or orders and by (iii)) high intraday message rates which constitute orders, quotes or cancellations, even without service function for third parties."

The reference to "on own account" in the definition indicates that it is only those entities who trade on their proprietary capital that should be caught by the definition. Indeed, in the Markets in Financial Instruments Directive (MiFID)1 defines "dealing on own account" to mean: "trading against proprietary capital resulting in the conclusion of transactions in one or more financial instruments." On that basis, as applied to investment funds the general view is that investment funds do not deal on their own accounts since investment funds do not trade their proprietary capital; rather, an investment manager makes portfolio management decisions on behalf of the fund (and the investment manager in doing so does not trade against its own proprietary capital).

Notwithstanding the above interpretation of "dealing on own account",2 however, on 6 December 2013 BaFin updated its FAQs (dated 4 November 2013) with a specific FAQ in relation to non-EU investment funds.3

The new FAQ is as follows:

**Question:** "What applies to investment funds from non-member countries?"

**Answer:** "Whether investment funds from non-member countries or their managers fall under the German High-frequency Trading Act (Hochfrequenzhandelsgesetz) or not can only be assessed on a case-by-case basis

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1 Directive 2004/39/EC. MiFID is currently being revised, but the definition of "dealing on own account" is unlikely to change.

2 The HFTA is not, in any event, tied to MiFID; it is specific to Germany only.

3 The FAQs are available in the English language at [http://www.bafin.de/EN/DataDocuments/FAQ/HFT-Gesetz/hft-gesetz_node.html](http://www.bafin.de/EN/DataDocuments/FAQ/HFT-Gesetz/hft-gesetz_node.html)
and by taking into account how exactly the activity is intended to be performed in the Federal Republic of Germany. We recommend contacting BaFin and providing all relevant details including any agreements entered into in order to have such individual cases assessed."

It is unclear why BaFin has chosen to address the new FAQ solely in relation to non-EU investment funds (or their managers) rather than investment funds generally, regardless of domicile. The FAQ implies that a UK investment manager managing an Irish fund would not need to consider whether to contact BaFin for such an assessment, while a U.S. investment manager managing a Cayman fund would need to consider contacting BaFin. It is less clear what happens where the investment manager is in the EU and the fund is outside the EU (or vice versa). The reference to "or their managers" appears to suggest that, where either the investment manager or the fund is outside the EU, this new FAQ becomes applicable.

Where the investment manager/fund decides to contact BaFin, we understand that it may be asked to provide information on the legal form of the investment fund, the relationship between the fund and the investment manager, and the manner in which the fund trades financial instruments listed on the relevant stock exchange.

Investment funds and their managers will need to consider fairly quickly whether to contact the BaFin in the manner suggested by the FAQ. The authorization requirement for high-frequency trading in respect of non-European entities takes effect as of the end of the transitional period, which is 14 February 2014.

If you have any questions regarding this update, please contact one of the following Sidley lawyers:

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