Algorithmic trading in India: Concerns, research and regulation

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IGIDR Finance Research Group

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Sep 1, 2016
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Background

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- **Earlier**, manual trading was the dominant form of trading.
- **Now**, algorithmic trading, AT (or its close kin, HFT) dominates trading activity worldwide.
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**Earlier**, manual trading was the dominant form of trading.

**Now**, algorithmic trading, AT (or its close kin, HFT) dominates trading activity worldwide.

Similar is the case in India as well.
Algorithmic trading (AT): The use of algorithms to monitor the markets and manage the trading process.
Definitions

- **Algorithmic trading (AT)**: The use of algorithms to monitor the markets and manage the trading process. – can be at any frequency.

- **High frequency trading (HFT)**: Algorithmic trading at high frequency.
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- **High frequency trading (HFT):** Algorithmic trading at high frequency.

  **Ambiguity here:** How to define and identify HFT?
Defining HFT

- **SEC’s definition**: HFTs are **proprietary trading firms** that use high speed systems to monitor market data and submit large numbers of orders to the markets.

- They are characterized by:
  1. the use of **extraordinarily high-speed** and **sophisticated computer programs** for generating, routing, and executing orders;
  2. use of **co-location services** and individual data feeds offered by exchanges and others to minimize network and other types of latencies;
  3. **very short time-frames** for establishing and liquidating positions;
  4. the submission of numerous orders that are **cancelled shortly** after submission; and
  5. ending the trading day in as close to a flat position as possible.

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With the rise in AT, HFT, benefits indisputable. However, concerns regarding possible negative impact. These include:

1. HFT are primarily liquidity takers, and flee the markets during stress periods.
2. AT, HFT engage in market manipulative activities.
3. Could increase the level of systemic risk in the markets.
4. Creates a two-tiered market structure which favors those with access to high speed.
Validity of the concerns remains questionable.

Much of the empirical evidence suggests that AT has indeed improved market quality.
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No empirical evidence on how AT is hurting the markets.

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- No empirical evidence on how AT is hurting the markets.
- Issues like market manipulation have existed since long.
- Several concerns are based on what has been seen in the US.
- But the structure of the US markets is very different from that of the Indian markets (or even markets elsewhere).
- Yes, the ability to trade faster has changed the structure of the markets.
- But important to understand how it has changed in order to know the implications.

Thus, the need for data analysis.
Research on AT, HFT in India constrained by data issues and capacity constraints.

Two studies in the context of NSE equity markets:

1. Boehmer and Shankar (2013) find that increase in AT does not result in high levels of systemic risk.
2. Aggarwal and Thomas (2014) find that higher AT improves market liquidity, reduces volatility and increase price efficiency.
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1. Boehmer and Shankar (2013) find that increase in AT does not result in high levels of systemic risk.
2. Aggarwal and Thomas (2014) find that
   1. higher AT improves market liquidity, reduces volatility and increase price efficiency.
   2. does not increase the incidence of extreme price movements.
   3. key: improvement in market quality of small market cap stocks.
Research at IGIDR

1. How has the market structure changed in terms of trading behavior and liquidity provisioning?
2. How has AT affected market quality? Does higher AT cause higher incidences of price instability?
3. Do AT's flee the markets during stress periods?
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2. How has AT affected market quality? Does higher AT cause higher incidences of price instability?
3. Do AT’s flee the markets during stress periods?

Data details

1. Tick by tick orders and trades data from NSE, timestamped in jiffies from 2008 onwards
2. Each order and trade marked by the exchange as AT or non AT.
3. Using this data, order book is re-created.
4. But note, this data do not have any information on trader’s ids.
Gigantic data from NSE

- Data size: more than 80 GB per day
- Systems at IGIDR:
  1. 48 CPU cores
  2. Memory: 320 GB
  3. Storage: 99TB
Non AT have equal and high share in trades, indicating that AT do not crowd out non AT.

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Do AT supply liquidity or demand liquidity?

The share of ATs in liquidity demand matches with their share in liquidity supply in all segments except options.
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What is the fill rate and the cancellation rate on NSE?

**Stocks:**

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*All values in %*

Significant increase in cancellations – a well documented phenomenon worldwide. Can have legitimate reasons.

Aggarwal, Anand, Thomas, *Algorithmic trading in India: Concerns, research and regulation*
Is high percentage of cancellations indicative of *fleeting orders*? Evidence on orders cancelled in $< 1 \text{s}$

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Less than 8% of the fast orders cancellations at the best prices. A majority of the fast order cancellations occur away from the best prices.

Aggarwal, Anand, Thomas

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Part I

Impact of AT on market quality
Cross-sectional variation in AT

Q1 2009

Q3 2013
What we find

- Compare the market quality of stocks with higher AT versus the ones with lower AT.

We find:
- Market quality of (small cap) stocks with high AT is better than the market quality of stocks with lower AT.
- The above is true for liquidity, price efficiency as well as price volatility.
- Does higher AT cause higher incidences of extreme price movements?
  - We analyse intra-day price movements by asking how frequently:
    - Traded prices move by 2%, 5% or 10% in a period of 5 minutes.
  - We find: Stocks with higher AT have lower percentage of such price movements in comparison to the stocks with lower AT.

The evidence indicates that AT improves market quality and does not increase the incidence of extreme price movements.

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Globally, regulators have been very cautious in introducing interventions on AT.
Globally, regulators have been very cautious in introducing interventions on AT – liquidity concerns.

Undertaken extensive research and consultative approach before introducing any regulation.

Key regulations:

1. Registration of AT. Emphasis on testing, monitoring and reporting of changes in algorithms.
2. Pre-trade risk measures such as maximum order size, price, position limits.
3. Post-trade risk measures such as trade reporting, order throttles.
4. Strengthening the surveillance system at the level of exchanges as well as regulators.
5. Real time monitoring of trading activity (MIDAS, ASIC).
Existing measures for AT, HFT regulation in India

- **Pre-trade controls**: Trading limits, position limits and exposure limits for all clients.
- Mandatory requirement at the level of broker to carry **validations of all risk parameters** including (but not limited to) quantity limits, price range checks, order value and credit checks.
- Order to trade ratio restrictions and penalties on orders from algorithmic traders.
- System audit of algorithmic trading system every six months.
- Directed the stock exchanges to strengthen their surveillance mechanism to prevent market manipulation.
Proposes **seven measures** which primarily focus on reducing the latency advantage of co-located traders.

**Does not** demonstrate market failure using hard evidence, does not indicate **how benefits outweigh the costs**.

**Lacks clarity.** Example: With already existing measure such as OTR fee, does not justify the need for maximum message to trade ratio.

Unless carefully analysed, the proposal measures may result in several unintended consequences.
In summary,

- Technology is here to stay, need to manage its usage rather than reduce it.
- Algorithmic trading is only a more speedy powerful mechanism to manage trading process.
- Humans still are in charge of what goes on exchange platforms.
- No evidence that higher AT adversely affects the markets.
- Good regulation making must be based on **scientific evidence** and **extensive consulting**.
- Given the access to data, it is important to
  - Identify the areas of concerns in the context of the Indian markets.
  - Demonstrate market failure, review past regulations and study the impact.
  - Analyse the costs and benefits of the interventions.
- Consider market solutions such as ‘Long life orders’, analyse the global experience.
- Blanket interventions extremely costly. Any intervention must be first rolled out on a pilot basis (eg. SEC tick size pilot).


Thank you

Comments / Questions?

http://www.ifrogs.org/