Regulation of Algo Trading

Why in news?

The Securities and Exchange Board of India (SEBI) has issued a discussion paper on regulating algorithmic trading.

What is Algo Trading?

- Algorithmic trading or Algo trading is computer assisted buying and selling of stocks.
- It is also known as automated or programmed trading, since trades are generated out of automatic execution of pre-programmed computer strategies based on set of parameters, instructions or market pattern and conditions.
- Algo trading came to India in 2008, but only savvy traders were using it then.
- In the past 5 years, retail traders have started using advanced algos for trading mainly due to its **speed of order execution.**
- Before algos came into play, retail traders had to either call their brokers to execute trades or be physically present at the nearest broker's office.

How does it work?

- Traders can deploy their pre-programmed algorithms by connecting them to a broker's trading terminal, which is in turn is linked to a stock exchange server.
- The Algo trading system automatically monitors the live stock prices and initiates an order when the given criteria are met.
- This frees the trader from having to monitor live stock prices and initiate manual order placement.
- Mobile trading is also a form of algo trading, where orders are executed via apps.
- Order execution without human intervention is an advanced form of algo trading. Around 50% of the daily trading volume in Indian stock markets is through this form.

Why is the SEBI trying to regulate Algo Trading?

- SEBI and stock exchanges regulate and monitor broker terminals, but the algo programmes deployed by traders did not require any exchange approvals so far as there were no rules.
- But SEBI now believes that unregulated/unapproved algos pose a risk to the market as a number of cases have been reported of retail clients losing money based on false promises made by some vendors.
- The unapproved algos can be misused for systematic market manipulation as well to lure retail investors by guaranteeing them higher returns.
- As Algo programmers sell their strategies like assured return products, the potential loss in the case of a failed algo strategy is huge for retail investors.
- Algo trading became controversial in 2015, when it was revealed that NSE gave preferential access to a few algo traders.

How does the SEBI propose to do it?

- SEBI wants every algo trading strategy and programme to be approved by the exchanges before they are deployed by traders.
- It has also said that there should be clarity on whether the services offered by third-party algo providers are in the nature of investment advisory services based on research and analysis done by them.
- It wants the exchanges to develop a system to ensure that only those algos which are approved and have a unique ID are deployed.
- Also, brokers will deploy suitable technological tools to ensure that appropriate checks are in place to prevent unauthorized altering or tweaking of algos.
- Currently, exchanges are providing approval for the algo submitted by the broker.

Will it hurt volumes at the stock exchanges?

- Brokers say algo trading volumes could fall once the proposed SEBI norms are implemented, since approval of pre-programmed trading strategies by the exchanges could be a complex affair.
- Also, submitting algo programmes to exchanges for their approval, would mean that vendors may have to reveal their formula.

Reference

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