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Mainland China issued new rules on algorithm trading

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Mainland China stock exchanges recently issued new rules on algorithm trading, as part of the continuing regulatory efforts to ensure the stability of the financial market.

Investors may need to ask a number of key questions when assessing the implication of the new rules, including

- Whether their trading activities fall within the statutory definition of Algorithm Trading (*defined below*) thus are captured by the new rules. Not all trading activities involving algorithm would necessarily be categorized as Algorithm Trading;
- Whether they are a type of "investors" captured by the new rules. The new rules apply to qualified foreign institutional investors (**QFII**) but not foreign investors trading PRC onshore securities via the Mainland Hong Kong Stock Connect regime;
- Whether each of the relevant thresholds on trading frequency, speed, portfolio size, leverage ratio and so on should be assessed at the account, product / fund or manager level; and
- Last but not the least, how they should manage the regulatory reporting with the right level of details. Our prior experience with securities regulator's investigation in algorithm trading points to a delicate balance between transparency and flexibility.

Key points of the new rules

On 1 September 2023, the Shanghai Stock Exchange, the Shenzhen Stock Exchange and the Beijing Stock Exchange, under the guidance of the China Securities Regulatory Commission, respectively formulated and issued the *Notice on Matters Related to the Reporting of the Stock Algorithm Trading* (the **Reporting Notice**) and the *Notice on Strengthening the Regulation of Algorithm Trading* (the **Regulation Notice**, and together with the Reporting Notice as the **New Algorithm Trading Rules)**[1], to put the use of Algorithm Trading under closer scrutiny.

The New Algorithm Trading Rules will take effective from 9 October 2023. The Reporting Notice provides a grace period of 60 trading days for the relevant investors to complete their reporting. No investor is permitted to conduct Algorithm Trading on PRC onshore stock exchanges without first reporting to the relevant stock exchange regarding their Algorithm Trading.

Relevant investors conducting Algorithm Trading will also be subject to closer surveillance by PRC onshore brokers and stock exchanges for the purpose of preventing abnormal trading activities. Investors who have triggered the Escalated Threshold (*defined below*) will be subject to additional reporting and strengthened surveillance requirements. Investors violating the aforementioned rules may be subject to disciplinary measures by the stock exchanges (and potentially more serious regulatory consequences depending on the nature and severity of the relevant irregularities). Stock exchanges may conduct onsite or offsite inspections over parties involved in Algorithm Trading.

The Reporting Notice sets out more details of the reporting requirement for Algorithm Trading of stocks and clarifies which investors are subject to this requirement (**Covered Investors**) (*see details below*). Information required to be reported includes, among others, the size and source of investment proceeds (including proprietary funds and leveraged funds respectively), leverage ratio, the strategy of the Algorithm Trading and brief description of the strategy, trade order execution methods, the highest frequency to input trade orders, and the largest number of orders to be placed on each single day. Investors who have triggered the Escalated Threshold are also required to report additional information such as the location of the server operating the Algorithm Trading system, test report of the Algorithm Trading system, and contingency plan in the case of malfunction of the Algorithm Trading system.

Investors are expected to abide by the envisaged trading activity described in their report. An amendment must be submitted in the case of any material deviation. We have seen deviation (without reporting) being treated as a regulatory breach.

Key definitions

Algorithm Trading is defined by the New Algorithm Trading Rules as securities trading activities on the relevant exchange where trading orders are generated and placed by computer programs, including, among others: (A) quantitative trading that automatically selects specific securities and timing for trading according to the preset strategy, (B) algorithm trading that automatically executes trading orders according to the preset algorithm, and (C) other activities entailing the features of algorithm trading.

Escalated Threshold: Investors whose highest speed to place trading orders reaches 300 orders or above per second, or whose maximum number of orders placed per day reaches 20,000 orders or more.

Covered Investors that are required to report to stock exchanges before the commencement of Algorithm Trading of stocks are those who,

(1) have a high degree of order placement automation where the core elements of the order instructions, such as the securities code, buy or sell direction, and quantity and price in the order, as well as the time of issuing the order, are all determined by the computer automatically;

1 The Regulation Notice technically covers the Algorithm Trading of a wider range of instruments tradeable on stock exchanges, including stocks, funds, bonds, depository certificates etc., whilst the Reporting Notice is only pertaining to the Algorithm Trading of stocks.

(2) place orders in high speed that reaches at least 10 occurrences of submitting (including canceling) at least 10 orders within one second in one day;

(3) hold a high number of stocks, with high turnover rate i.e. trade no less than 50 stocks on one stock exchange on average per day in the last 30 trading days, and whose annualized turnover rate in the last 30 trading days is above 30 times;

(4) use self-developed or other customized software; or

(5) Others that are required to adhere to the reporting requirement as determined by the exchange.

Investors who trade using an application for customers with certain automation functions provided by their brokers, and who do not meet the above conditions, are not required to report under the Reporting Notice.

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