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Program trading in China will be regulated

The significant drop in the value of China's stock market since June 2015 has prompted the China Securities Regulatory Commission (CSRC) to initiate an investigation on its securities and futures markets. Program trading, which features frequent order submission and cancellation, seems to be believed as one of the reasons causing market volatility. Since July 2015, the Shanghai and Shenzhen Stock Exchanges have restricted the use of certain accounts that were suspected of interfering with stock price or misleading investors by frequent order submission and cancellation.

With the A-share market gradually becoming more stabilized, in the absence of existing specific regulation, CSRC issued the consultation draft of the *Administrative Measures for Program Trading on the Securities and Futures Markets* (CSRC Consultation Draft) on 9 October 2015, with a view to supervising program trading in the securities and futures markets. CSRC explains that the CSRC Consultation Draft is aimed to correct deficiencies and minimize risks which have emerged with the rapid development of program trading in China. At about the same time, the stock exchanges and futures exchanges in China have respectively published their own draft exchange rules on program trading in line with the CSRC Consultation Draft.

Overview of the CSRC Consultation Draft

Pursuant to the CSRC Consultation Draft, "program trading" is broadly defined to cover trading on orders automatically generated or executed through a designated program or particular software. The CSRC Consultation Draft outlines the general administrative framework for program trading on the domestic stock/futures exchanges as discussed below.

Information reporting for program trading

The CSRC Consultation Draft imposes information reporting requirements on domestic program trading. Program traders may only carry out program trading on the domestic stock/futures exchanges after the required information they have submitted is verified. Specifically, the CSRC Consultation Draft stipulates that:

(1) clients of the securities/futures companies (which act as brokers) intending to conduct program trading must, in advance, report the relevant information to the securities/futures companies, including their identity, strategy, technical configuration parameters of the program trading system, location of server and contact person. The securities/futures companies may only accept program trading entrustment by clients after verifying the relevant information. They must also file the relevant information with the relevant stock/futures exchanges; and

(2) members of the stock/futures exchanges and fund management companies must provide information on their program trading under their own proprietary or asset management business to the stock/futures exchanges. They may only carry out program trading after verification of information by the stock/futures exchanges.

According to the CSRC Consultation Draft, CSRC may, for regulatory enforcement purpose, also require program traders to provide their source codes of the trading program, detailed explanations of their trading strategy and other relevant materials.

Requirements on program trading systems

Program traders are required to equip their trading systems with necessary risk control functions, such as capital verification, securities verification, position verification, detection of irregularity and correction of error.

Under the CSRC Consultation Draft, if a client were to connect its program trading system to the internal system of a securities/futures company, the securities/futures company must carry out verification, examination and risk evaluation before allowing access. The securities/futures company must further execute an access agreement with the client, which must specify the following matters:

(1) the client cannot provide services to a third-party via its trading system connected to the securities/futures company;

(2) the trading system used by the client must be the same as the system that has been subject to the verification, examination and risk evaluation by the securities/futures company; and

(3) if any significant irregularity occurs to the trading system of the client, the securities/futures company may take measures including refusing the entrustment of the client and removing access to its system.

Restriction on offshore remote control and co-location

The CSRC Consultation Draft specifically prohibits *domestic* program traders from making trading orders through trading systems installed offshore, or connecting onshore trading systems with offshore computers and subjecting onshore trading systems to the remote control of offshore computers, unless otherwise provided by CSRC. These measures will effectively prohibit a foreign trading house from setting up an onshore presence to engage in program trading controlled by its offshore system. As a result, some existing trading models may need to be revamped and improved to comply with the new requirements. It is worth noting that this prohibition applies specifically to domestic program traders. Whether qualified foreign investors who trade from offshore are excluded remains to be further clarified.

The CSRC Consultation Draft permits the stock and futures exchanges to provide server custody services (i.e. co-location). Securities and futures brokers must reasonably utilize such services and allocate their trading units or seats based on the principle of fairness. In addition, they may not be unfair to clients by only providing services to other clients at a higher submission speed.

Risk control measures

To minimize the potential volatility on price or liquidity and to ensure stable market operation, the CSRC Consultation Draft has imposed various risk control measures on program trading, which include:

(1) all program trading orders must be verified by the relevant securities/futures broker of the client. The securities/futures broker may refuse the program trading entrustment of the client if it considers that its trading order may have a significant impact on market price and liquidity;

(2) program trading by securities companies under their proprietary and asset management business, or by fund management companies on the stock exchanges may be subject to a daily quota on the net purchase volume of securities which is to be verified or adjusted by the stock exchanges. Program traders on the futures exchanges must be subject to intra-day position opening limits formulated by the futures exchanges; and

(3) if any irregularity occurs to a client's trading system, the client must immediately take effective control measures and report to its securities/futures broker. The securities/futures broker must then promptly report to the relevant stock/futures exchange, following which the exchange may take measures including technical suspension of trading or a temporary closure of the market as may be necessary.

Prohibited behaviors and regulatory implications

The CSRC Consultation Draft has specified certain prohibited program trading behaviors such as:

(1) trading the same securities between the accounts of the same person, accounts under common control or suspicious affiliated accounts;

(2) buying and selling the same futures contracts under the same account or between the accounts controlled by the same client;

(3) frequently submitting and cancelling orders such that execution is way below a normal level; and

(4) utilizing the trading system to carry out large volume and consecutive transactions at the close of the market, affecting the closing price.

The CSRC Consultation Draft also contains a catch-call prohibition against all trading behavior that violate the *PRC Securities Law*, the *Administrative Regulations for Futures Trading* or other laws and regulations that affect the normal trading order of the securities/futures market.

According to the CSRC Consultation Draft, program traders who engage in any prohibited trading behavior will be subject to regulatory measures taken by CSRC. CSRC may also impose administrative sanctions against the program trader or take the case to criminal investigation if a criminal offence is suspected to have been committed.

Draft rules published by the exchanges

Relevant stock and futures exchanges including the Shanghai Stock Exchange (SSE), Shenzhen Stock Exchange (SZSE), China Financial Futures Exchange (CFFEX), Shanghai Futures Exchange (SHFE), Dalian Commodities Exchange (DCE) and Zhengzhou Commodities Exchange (ZCE) have issued their respective draft rules on program trading in line with the CSRC Consultation Draft. While the CSRC Consultation Draft is intended to provide the general regulatory framework on program trading, the draft rules of each Exchange set out the detailed trading requirements for that particular exchange. Generally speaking, the draft rules of the exchanges emphasize information reporting, quota control, monitoring and address the ways to handle abnormal trading and differentiated fee arrangement. We set out below a very high-level general overview and comparison of the rules of the stock exchanges and the futures exchanges.

<table>
<tr><th></th><th>Stock Exchange Rules
(SSE and SZSE)</th><th>Futures Exchange Rules
(CFFEX, SHFE, DCE and ZCE)</th></tr>
<tr><td>Information Reporting</td><td colspan="2">• A client must report relevant information to the securities/futures company (as broker) three trading days prior to conducting program trading.
• Required information to be reported includes (among others) investor identity, account/trading code information, investment strategy, source of funds, asset size of the trader, technical configuration parameters of the program trading system, location of server, developer of the program trading system and contact information.
• Acceptance of the information filed by an exchange does not mean that the exchange has agreed with the compliance or suitability of the program trader or trading system.</td></tr>
<tr><td>Quota/Limit Control</td><td>• Daily quota on the net purchase volume ("Quota") is applicable to A shares, funds and other products designated by the stock exchange.
• Quota = aggregated amount of buy orders – aggregated amount of executed selling orders – aggregated amount of cancelled buy orders</td><td>• Intra-day position opening limit for program traders is to be determined by the futures exchange.</td></tr>
</table>

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<tr><th></th><th>Stock Exchange Rules
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(CFFEX, SHFE, DCE and ZCE)</th></tr>
<tr><td>Abnormal Trading</td><td colspan="2">The exchanges will closely monitor abnormal trading activities including (without limitation to):
• frequent order submission and cancellation or order cancellation following the placing of high-pricing orders (with no purpose of execution);
• frequent order submission and cancellation or order cancellation following the placing of high-price orders within a confined price range;
• submitting large volume orders at prices that consistently deviate from the market price to mislead other investors in decision-making, and simultaneously submitting and executing multiple reverse orders in small volume;
• continuously making purchase orders at a price higher than the latest trading price or making sell orders at a price lower than the most recent trading price, which leads to rapid price change, and submitting, and executing reverse orders in large-volume after leading and enhancing the trend of the prices;
• carrying out large-volume and consecutive transactions at the close of the market and affecting the closing price; and
• trading the same securities between the accounts of the same person or accounts under common control or suspicious affiliated accounts.
The exchanges can impose self-disciplinary measures including restriction of trading against program traders who conduct abnormal trading on the exchanges.</td></tr>
<tr><td rowspan="2">Differentiated Fee Arrangement</td><td>(1) No additional fee charged if Cancel Ratio < 40% and Fill Ratio >60%
(2) RMB 2 per transaction charged if Cancel Ratio >70% or Fill Ratio < 30%
(3) RMB 0.2 per transaction charged for all other program trading transactions not under (1) or (2) above
Cancel Ratio = Number of cancelled orders ÷ Number of submitted orders
Fill Ratio = Number of executed orders ÷ Number of submitted orders</td><td>For SHFE, DCE and ZCE:
• Additional fee to be charged if number of cancelling orders for one contract in one day > 500 and Execution to Cancel Ratio<10%
• Additional fee = Trading commission fee × Additional fee rate / Execution to Cancel Ratio
• Execution to Cancel Ratio = Number of executed orders ÷ Number of cancelled orders
For CFFEX, no specific fee arrangement is available yet.</td></tr>
<tr><td colspan="2">The above additional fees may be waived or reduced by the exchange for market-makers or liquidity providers for certain products.</td></tr>
</table>

Outstanding issues

Many issues remain to be answered before the CSRC Consultation Draft is finally promulgated. For example, it is unclear whether and how Hong Kong securities brokers would be subject to the relevant obligations under the Northbound trading link of the Shanghai - Hong Kong Stock Connect program. Whether the rules should apply equally to qualified foreign investors such as QFIIs and RQFIIs also needs to be clarified.

Conclusion

The CSRC Consultation Draft has marked an important step towards the regulation of program trading on the domestic stock and futures markets. Once promulgated, it will, for the first time, serve as a comprehensive legal framework that will guide investors on the regulatory parameters relating to program trading and on all necessary compliance requirements.

The consultation period of the CSRC Consultation Draft and the draft rules issued by the exchanges will end on 8 November 2015. Clifford Chance is working with market participants to put together important issues arising from the CSRC Consultation Draft for due consideration by the CSRC. We will provide further update as this matter progresses.

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