

Legal Commentary

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CSRC to Fill in Gaps in Program Trading Regulation

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On April 12, 2024, the China Securities Regulatory Committee (“**CSRC**”) released a public consultation draft of the *Provisions on Program Trading Management in Securities Markets (for Trial Implementation)* (《证券市场程序化交易管理规定(试行)(征求意见稿)》), the “**Draft Provisions**”). The consultation period will end on April 27, 2024. The Draft Provisions are the first comprehensive rules on program trading to be issued at the central financial regulator level, which intend to address a series of critical issues relating to program trading in China’s securities markets.

Background

Despite its relatively late introduction in China, program trading has rapidly developed, now accounting for over 25% of the trading volume in the A shares market. The amended *PRC Securities Law* promulgated in 2019 expressly provides for program trading under the supervision of CSRC, establishing a legislative basis to further regulate program trading for ensuring systematic security and maintaining orderly markets. In September 2023, the three PRC stock exchanges, under CSRC’s guidance issued their guidelines on program trading and reporting. The market has been awaiting CSRC’s regulation in this area to provide traders with more certainty and transparency, thus industry players have welcomed the Draft Provisions as a positive regulatory development.

The Draft Provisions were formulated while recognizing both the benefits and downsides associated with program trading, drawing on practical experience and statistical analysis to create a framework that enhances the pertinence and effectiveness of relevant regulatory measures.

The Draft Provisions follow the State Council’s issuance of the *Opinions on Strengthening Regulation, Forestalling Risks and Promoting the High-Quality Development of the Capital Markets* (《关于加强监管防范风险推动资本市场高质量发展的若干意见》), which outlines a strategic vision to develop a modernized, adaptive, competitive, and inclusive capital market by 2035. The Draft Provisions will form a critical component of this broader initiative, aimed at enhancing market stability and safeguarding investor interests through a robust system of monitoring and risk management.

Key takeaways of the Draft Provisions

The Draft Provisions consist of 7 chapters and 32 articles, with the following key aspects worth noting among others:

I. Definition of “program trading” and application scope

- Under the Draft Provisions, “program trading” is generally defined as trading on securities exchanges via trade orders automatically generated or placed by computer programs.
- “Program traders” refer to investors engaging in program trading which may include (i) clients of securities firms, such as private fund managers, private funds and QFIs; (ii) securities firms that engage in proprietary trading, market making or asset management businesses; (iii) mutual fund managers, insurance institutions and other institutions trading through trading units of the exchanges; and (iv) other investors as identified by the exchanges.
- Overseas program traders under the Stock Connect Northbound trading link will be equally covered under the Draft Provisions. Detailed measures to facilitate this inclusion are pending further coordination and agreement between exchanges on both sides.

II. Regulatory jurisdiction and authority delegation

- A multi-layer regulatory framework is intended, where CSRC will be the key regulator to supervise program trading related activities, and relevant exchanges and industry associations will formulate trading rules for self-regulation purpose and set up information and monitoring systems under CSRC’s guidance.
- CSRC, relevant exchanges, and industry associations may conduct onsite and offsite examinations on relevant institutions and individuals involved in program trading, and the Draft Provisions would permit CSRC to impose penalties or discipline on traders who are found to be in violation.

III. Reporting system

- A detailed program trading reporting system will be established by the exchanges under which all program traders would be subject. Generally, the key reportable items include account information, funding information, trade information, software information, etc.
- Brokers would be required to have their clients report relevant information to them, whereas institutions trading through trading units would report to the exchanges. Program traders would be allowed to engage in program trading only after receiving confirmation of the reported information from the brokers or the exchanges, as applicable.

IV. Trade monitoring and risk management by exchanges

- The exchanges would need to pay more attention to certain abnormal trading activities, including rapid order placement, high frequency of cancellation, and those causing irregularities in multiple securities or the market.

- Brokers would enter into program trading entrustment agreements to specify brokers' risk management responsibilities and requirements. The exchanges would need to clarify the specific procedures and requirements for trading suspension, order cancellation, settlement delay, etc., to resolve market disruptions due to force majeure, accidents, major technical failures, human errors or other emergencies.

V. Requirements for technical systems used in trading

- The technical system used for program trading would need to conform to the requirements of the exchanges, and feature effective functions such as capital and securities inspection, authorization control, threshold management, abnormality monitoring, error handling, and emergency disposal, etc.
- To ensure fair treatment among market players, a series of requirements with respect to trading unit, colocation service, system access and market information will apply to relevant parties including program traders, brokers, and the exchanges.

VI. High Frequency Trading/HFT

- HFT under the Draft Provisions refers to program trading activities that feature (i) high amount and frequency of order placement and cancellation within a short period of time; (ii) high amount and frequency of order placement and cancellation within a day; and (iii) other features identified by the exchanges.
- HFT would become a focus of regulatory monitoring and be subject to additional reporting requirements and differentiated fees imposed by the exchanges.

Our observations

The Draft Provisions are formulated with the strategic approach of “drawing on advantages and avoiding risks”, particularly considering the extensive presence of retail investors in China’s market landscape. In principle, the Draft Provisions aim to leverage the benefits of program trading while rigorously standardizing trading behaviors and effectively curbing illegal or abnormal activities that could disrupt orderly markets. The Draft Provisions also seek to fill in existing regulatory gaps, thereby enhancing predictability and transparency for program traders and fostering a friendlier trading environment in the long run.

There are no major differences between the Draft Provisions and the program trading rules previously issued by the three PRC stock exchanges, which have already demonstrated the regulatory intention and effectiveness in guiding the practices. These exchanges have also emphasized their commitment to actively implementing the new regulation once it is finalized.

Meanwhile, market participants are presented with an excellent opportunity to engage with CSRC by submitting their comments and feedbacks. This involvement is crucial as it helps refine the regulation as appropriate, ensuring they effectively address the needs and concerns of all stakeholders while enhancing the stability and integrity of the capital markets.

We will continue to make bridging efforts between the industry and the regulators and navigate our clients through this evolving regulatory environment. We have prepared an inhouse English translation of the Draft Provisions. Please do not hesitate to contact us if you have any questions or require a copy of the translation.

Important Announcement

This Legal Commentary has been prepared for clients and professional associates of Han Kun Law Offices. Whilst every effort has been made to ensure accuracy, no responsibility can be accepted for errors and omissions, however caused. The information contained in this publication should not be relied on as legal advice and should not be regarded as a substitute for detailed advice in individual cases.

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