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Criminal regulation of high frequency trading on China's capital markets

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ABSTRACT

The securities regulatory authority and judicial department launched investigation into allegations of market manipulation by high frequency trading companies after the recent capital market crash in China. But in the absence of any criminal prosecutions under Article 182 of the Criminal Code of the People's Republic of China till now, the potential scope of the criminal violation of market manipulation remains uncertain in the context of high frequency trading. Notwithstanding the fact that high frequency trading is not ostensibly referred as one of the forms of criminal behaviors under Article 182, the statutory text of Criminal Code is sufficiently broad, and the mechanism of criminal law interpretation is legally and legitimately efficient, to catch high frequency trading schemes when the prosecutor can demonstrate that they have created a distorted price and (or) volume.

1. Introduction

The market events of May 6, 2010, in the US, known as the “flash crash” caused stock prices to plummet falsely and then sharply rise (SEC and CFTC, 2010). The event caused many to cry out for regulation of high frequency trading (HFT), an extremely fast, algorithm-driven and computer-based technique of financial trading, which has been perceived as a threat to the stability of capital markets.

Accounting for an estimated 60% of the US trading activity (Polansek, 2013), HFT is now a well-integrated feature of the international capital market mechanism. Many Chinese funds management companies now have also invested heavily in staff and technology to profit from China's recently developed derivatives markets and from using HFT to make money from small movements in stock prices, as in the U.S. (Shen and Sweeney, 2015). The event similar to “flash crash” also has transpired in China, which is known as the “fat-finger”. On August 16, 2013, there was an unexpected large volatility in the CSI 300 index, SSE (Shanghai Stock Exchange) Composite Index and their trading volume within three minutes of an erroneous computer program placing trades by China Everbright Securities. Everbright Securities tried to hedge its risk by selling 1.415 billion RMB in exchange traded funds (ETF) and executed 6240 index futures contracts in the time before the news was officially released to the public. After the news was made public, the company sold another 475 million RMB in exchange-traded funds and executed another 890 index futures contracts. According to China Securities Regulatory Commission's (CSRC) Investigation, Everbright Securities gained approximately 87 million RMB during the whole event. The CSRC fined Everbright Securities 523 million RMB (six times the original gain) and banned it from some of its businesses including trading stocks on its own account for three months (CSRC Decision of Administrative Penalty, 2013). It is the increased use of HFT strategies using

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complex algorithm and automated trading strategies that has accelerated market activity across global exchanges, thereby leading to growing concerns that HFT renders financial market more fragile. Besides the systematic risks brought by HFT, it is natural to fear that a continued lack of regulation and the prone to pernicious manipulation of HFT will allow for serious market abuse (Gould, 2011).

The US Department of Justice (DOJ) filed the first criminal complaint against a London-based trader, Navinder Singh Sarao, accusing that Sarao used manipulative HFT techniques to generate large sell orders, pushing down prices, which he then cancelled to buy at the lower market prices. According to the DOJ, Sarao created the misleading impression of high demand or supply of e-Mini futures and causing prices to move in favor of his other positions, which enabled him to make profits of $40 million (United States of America v. Navinder Singh Sarao, 2015).

In the wake of the capital market disaster in the summer of 2015, during which the Shanghai Composite Index fell over 33% from 15 June to 3 July (Peng, 2015), but the hedge fund equipped with HFT techniques and strategies acquired 4% growth of net value in average, even more than 100% growth individually (Yue et al., 2015), the Chinese regulators and police department started responding to HFT. In 9 July 2015, the Ministry of Public Security (MPS) declared to work with the China Securities Regulatory Commission (CSRC) to initiate the investigation of “malicious” short selling and algorithm trading of stocks and indexes. Next day, several corporations are located by MPS and CSRC and suspicious of utilize HFT strategies and short selling to manipulate securities and futures market (Xinhua News Agency, 2015). Heavy regulatory pressure was applied to trading automated trading strategies, especially the cross-market trades between stock market and index futures. The spokesman of CSRC even defined “malicious” short selling as cross-market manipulation or manipulation across the spot and futures market (Jiening, 2015). But many Chinese professional investors and scholars accused regulator's overreaction to the HFT strategies and meaningless definition of “malicious” short selling. Besides there is no further information disclosure from MPS or CSRC about how the investigation goes.

Meanwhile the Chinese government massively intervened on multiple fronts to rescue its stock market and index futures market, but it still struggled to produce a sustainable turnaround (Zhaojin, 2015a). The capital market continued plunging in the end of August 2015. In 24 August 2015, A-shares fell 8.99% with more than 2000 securities down by limit, which was a record fall after up and down limits were enforced in China's capital market (Xinran, 2015). Against the background that stock markets around the world plunged on 25 August, Shanghai Composite Index further fell 7.63%, close below the psychologically significant 3000-point level (Zhaojin, 2015b). Once again CSRC targeted those who use HFT to frequently submit and then cancel bids, thus disturbing the market and manipulating prices. CSRC restricted 42 financial trading accounts for suspected irregularities, including abnormal bids for shares and rapid bid cancellations that might have impacted wider market performance (Dan, 2015). Among these restricted accounts, only one of them was controlled by foreign investors owned company, Shanghai Sidu Trade Co., Ltd. (Sidu), which was a wholly owned subsidiary affiliated to Citadel, a multi-strategy hedge fund and global asset management company equipped with proprietary and advanced HFT techniques. Sidu participated in China's capital market with huge trading volume, over 1 trillion RMB during January to July 2015, and obtained huge profits from automatic trading program since 2010 (Xiaoxiao et al., 2015). MPS received 22 criminal cases from CSRC, which mainly are criminal violation of market manipulation (Dan, 2015). CSRC or MPS investigated, detained or arrested over 200 people, including 4 senior executives of CITIC Securities, China's leading securities dealer, under criminal compulsory measures for capital market criminal violations. In 2 September 2015, the China Financial Futures Exchange (CFFEX) introduced new measures to deter over-speculation, especially algorithm trading, after the shorting of stock index futures had been blamed for the massive sell-off in the stock market and making extra profits during the period of Chinese government's rescuing the market. Starting 7 September, the CFFEX raised margin requirements for non-hedging futures contracts to 40% of contract values. The margin requirements for futures contracts with hedging demand rose from 10% to 20%, while fees for settling positions that were opened on the same day were raised from 0.0115% to 0.23%. Moreover, opening more than 10 contracts on a single index-futures product on the indexes of CSI 300, SSE 50 and CSI 500 will be considered abnormal trading. These measures and requirements made HFT impossible within the legal operative framework in Chinese capital market. HFTers may face criminal risks if they escape the regulatory measures and continue to carry out their existing strategies and techniques in China's capital markets.

But the relationship between HFT and market manipulation is a complex and practical issue because of the mysterious and sophisticated nature of HFT and confused understanding about criminal violation market manipulation under Criminal Code of China. The fast trading speed and computing processing capacity combined with specific investment strategies enable HFTs pose a serious threat to manipulate the market. And it is difficult for regulators to detect illegal HFTs and for judicial department to criminalize market manipulation based on HFT. Criminal violation of market manipulation in itself includes a wider range of deficiently defined economic behaviors which imply the active creation of an unfair, artificial and distorted appearance of a financial instrument's price on the market (Avgouleas, 2005a). Therefore, in the absence of any prior prosecution and conviction in China, whether the capital market criminal law addressing market manipulation is reasonable enough to encompass the illegal use of allegedly abusive and manipulative HFT techniques is a potentially complex issue in the case.

Against the background of post-capital market disaster, the development of internet finance markets and evolvement of advanced trading programs in China, the application of the criminal violation of market manipulation established by Article 182 of the Criminal Code to particular forms of HFT attracts consideration both in academic and practical circles. The criminalization of certain capital market behaviors which severely impede market efficiency and investors' rights is the toughest regulatory mechanism of the financial markets. Article 182 is one of the most important criminal regulatory sections which