Will Sebi's latest plan to curb algo-trading backfire?

The Securities and Exchange Board of India (Sebi) is considering a proposal to impose a congestion charge to curb algorithmic traders who send large numbers of order messages to stock exchanges. If it isn't implemented carefully, the market regulator will be playing with fire. A wrongly calibrated message fee can impact liquidity and increase bid-ask spreads, and will hurt the very investors Sebi is trying to protect.

But first, the congestion fee proposal, or any regulation for that matter, begs the question: What market failure is the regulator trying to address? According to a person familiar with the regulator's thinking, the congestion charge is similar to a traffic tax that seeks to reduce congestion on roads.

Some algorithmic traders send a large amount of orders to exchanges, which are later either cancelled or modified, and don't end up in actual trades. The case for a congestion fee, according to this person, is to disincentivize traders who clog exchange systems with a disproportionately high amount of orders. After all, high-message traffic necessitates higher investments by exchanges for enhancing trading infrastructure and surveillance capacity, and imposes costs on other market participants and the regulator as well. As such, it makes sense for such costs to be borne proportionally by those who are imposing these burdens on the marketplace. A message fee fits well in this scheme of things.

The Australian Securities and Investments Commission (Asic) has charged market participants a message fee for years now, although the clearly stated intent there has been to recover its market surveillance costs. A drop in order-to-trade ratios has been one of the fallouts of Asic's move, although this was more of a by-product. Its cost recovery fee is calibrated at levels that help it meet its budget for market surveillance.

To start with, Sebi would do well to articulate the regulatory intent behind the congestion fee clearly. It needs to state where order-to-trade ratios are at currently, how it compares with other markets, and why it sees them as detrimental to the market.

And importantly, it needs to provide a cost-benefit analysis of the proposed congestion fee. Market-making firms that use algo-trading tools are quick to point out that such fees will invariably impact firms that provide liquidity to the markets. Market makers aim to provide two-way liquidity, while at the same time maintaining low inventory levels. If the market moves against them, they are among the quickest to cancel existing orders in the system.

If the regulator sets a message fee at a level that is seen as unviable by some traders, many of them would think twice about posting passive orders which can potentially be cancelled at a later stage. The firms that continue with market-making activities will demand higher spreads, which will hurt all investors. If things turn out this way, Sebi's move will be counterproductive.

Clearly, the message fee needs to calibrated in a way that it doesn't impede market makers who provide much-needed liquidity to the markets. Currently, Indian exchanges penalize traders whose order-to-trade ratios are higher than certain prescribed limits such as 50:1. But while calculating the ratio, exchanges exclude orders that are placed within a +/- 1% range from the last traded price. The aim behind this is to support market makers and penalize only those traders who unnecessarily clog exchange systems with orders that are unlikely to get executed.

Should Sebi consider a similar system with the message fee? Venkatesh Panchapagesan, associate professor, finance and accounting, at IIM Bangalore says that a 1% range applied to all stocks may not be effective in curtailing high messaging traffic, something he finds in a study he

did with researchers at Indira Gandhi Institute of Development Research. According to him, the fee should be levied based on the volatility of a stock/index, so that only genuine liquidity providers are excluded. The regulator could also consider excluding passive orders if they had remained exposed for a finite period of time, he adds.

The silver lining in the latest algo-trading proposal is that it isn't as bizarre as, say, the two-queue proposal Sebi flirted with for years to bring parity between sophisticated traders and less sophisticated traders. But even with the congestion fee, things can quickly get out of hand, if it's not implemented carefully. After having thought about algorithmic trading regulation for years now, hopefully Sebi won't let us down.

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