

SFC IMPOSES PENALTY SURCHARGE ON OVERSEAS-BASED FINANCIAL INVESTMENT ENTITY FOR MARKET DISTURBANCE

The Securities and Futures Commission (SFC), a sub-commission of the FSC responsible for the oversight of the securities and futures market, decided on January 26 to impose a penalty surcharge of KRW11.88 billion on an overseas-based financial investment business entity (“securities firm A” hereinafter) for disturbing market order with its high-frequency algorithmic trading activities. This is the first instance in Korea where authorities reached a decision to impose a penalty surcharge for market disturbance caused by high-frequency algorithmic trading activities.¹ With the growth in the volume of high-frequency algorithmic transactions recently, financial authorities will continuously strengthen the administration of market risks associated with them.

OVERVIEW

The SFC recognized that “securities firm A” engaged in an activity of disturbing market order in its transactions of a total of 264 stock items in 6,796 trading periods via a Seoul-based securities firm (“securities firm B”) between October 2017 and May 2018, and decided to impose a penalty surcharge of KRW11.88 billion on “securities firm A”, pursuant to the Article 429-2 of the Financial Investment Services and Capital Markets Act (FSCMA).

VIOLATION

“Securities firm A” engaged in trading activities using its algorithmic trading system, which enables it to acquire and analyze data on price quotation and trade executions as well as submit buy and sell orders via direct market access (DMA)² more quickly than ordinary retail investors. In the process, “securities firm A” placed orders intensively and repetitively within a short period of time in the following pattern—(a) placing immediate-or-cancel (IOC)³ buy market orders to exhaust all quantities of best ask prices in succession, and (b) submitting buy limit orders on any remaining unfilled quantity where there is no bid price given in order to newly generate the best bid price (inflating bid price) and then cancelling such transactions. Thus, a suspicion was raised that “securities firm A” had engaged in trading activities which is likely to mislead other investors into misapprehension or distort prices, etc. of that relevant stock item by artificial factors.

¹ A computer algorithm-based transaction for financial investment products which automatically decides the generation, price and period of orders as well as the method of management after orders are submitted.

² Direct market access (DMA) refers to a method in which traders can directly transfer orders (under the name of a securities firm) to the electronic system of the stock exchange to minimize the time it takes to execute orders.

³ An immediate-or-cancel (IOC) order is a type of order instructing the broker to execute all available quantity of order and cancel unfilled portion immediately.

For example, at around 10:00 am on May XX, 2018, “securities firm A” submitted a total of 34 IOC buy orders for a certain stock item—including 19 market orders to exhaust all quantities of best ask prices and 15 limit bid orders intended to fill gaps between the then best ask and bid price—which consequently pushed up the market price of that particular stock about 3.5 percent in approximately 60 seconds.

SFC’s FINDINGS

Regulation on market disturbances—introduced in 2014 and went into effect in July 2015—is intended to eliminate blind spots in regulation of unfair trading and to better protect investors. The regulation consists of the prohibition of certain types of unfair activities that are less serious in terms of the degree of illegality than traditional unfair trading practices but still undermine the soundness of the stock market as well as the introduction of penalty surcharge on such unfair trading activities.

After a holistic consideration of the intention of the regulation on market disturbances, specific traits of the Korean stock market, as well as time, number and scale of transactions that took place, the SFC opinions converged in that “securities firm A”’s trading patterns (repetitively placing market buy orders to exhaust quantities at best ask prices and limit orders to fulfill vacant quantities, etc.) qualify as activities disturbing market order. The SFC decided that these trading activities will be recognized as (a) having been likely to artificially change market prices and trading volumes which should be formed according to the normal supply and demand conditions in a free and competitive market; (b) having a considerable potential to mislead other ordinary investors into misapprehension that certain stock item is being traded actively contrary to the reality; and (c) having undermined the soundness of market with generally unaccepted method of trading.

Additional comments also attached: During the SFC’s deliberation process, “securities firm A” has not sufficiently explained that it had given ample consideration for the particular characteristics of Korean stock markets⁴ in employing its trading strategies, and it has not provided source codes which could have helped authorities better understand specific strategies behind its algorithmic trading.

The SFC found that, between October 18, 2017 and May 24, 2018, “securities firm A” had made daily transactions worth more than average KRW500 billion⁵ on average 1,422 stock items.

DIRECTION OF SUPERVISION ON HIGH-FREQUENCY ALGORITHMIC TRADING

The digitization and automation of securities transactions empowered by the advancement of information technology makes high-frequency algorithmic transactions spread throughout the world. Discussions on various risks and the possibility of unfair transactions associated with high-frequency algorithmic trading

⁴ High proportion of retail investors; low degree of competition between algorithmic trading platforms; and all transactions being displayed on the personally used home trading system (HTS).

⁵ Apart from the violation of disturbing market order, authorities imposed a fine of about KRW1.1 billion for violating the regulation on naked short-selling.

are also taking place actively in each country. Regarding this, financial authorities plan to continuously strengthen management of market risks related to high-frequency algorithmic trading in order to establish sound market order and bolster investor protections.

- a) **(TRADER REGISTRATION SYSTEM)** To strengthen risk management related to high-frequency algorithmic transactions, authorities will begin the registration process of high-frequency algorithmic traders and operate a risk management system for their trading.⁶
- From now on, investors who intend to make high-frequency algorithmic trading will be required to register⁷ with the Korea Exchange (KRX) prior to engaging in that trading, and the KRX will assign a separate identifier code to each registered trader which will be utilized to monitor their transactions.
 - Securities firms will carry the obligation of risk management such as preliminary examination on the order management system for high-frequency algorithmic traders in order to prevent order mistakes, etc.
- b) **(PROVIDE THE STANDARDS FOR MARKET OVERSIGHT)** To improve regulatory predictability for market participants, authorities will seamlessly enforce the KRX's standards for market surveillance (preventive measures) that are particularly tailored for high-frequency algorithmic trading.⁸ Making use of these standards, securities firms will be actively encouraged to autonomously prevent unsound trading activities of their clients using high-frequency algorithms. Meanwhile, authorities will continuously review and make improvements to these standards in the future.
- c) **(STRENGTHEN MARKET SURVEILLANCE)** In the first half of this year, the KRX will develop a system that can more easily discover and analyze abnormal trading activities involving high-frequency algorithms in order to carry out its market surveillance duty more effectively.⁹

In the mid- and long-term, authorities plan to consider ways to strengthen regulations on unfair trading activities involving algorithmic trading after reviewing regulatory systems of major economies.¹⁰

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For press inquiry, please contact Foreign Media Relations at fsc_media@korea.kr.

⁶ For details, please see the [KRX's press release](#) (regulation takes effect on January 25, 2023 → 3-month grace period → mandatory registration of high-frequency algorithmic traders from April 25).

⁷ Applicants need to have the stability and appropriateness of their computer network facilities, trading expertise and internal control management system.

⁸ An information session was held by the KRX in November 2022.

⁹ e.g. Strengthen detection of unsound trading activities, such as getting involved in the supply and demand of various stock items within a matter of few minutes to entice executions of transactions favorable to one's own position.

¹⁰ (Europe) EU's market abuse regulation deals with market manipulation based on high-frequency algorithmic trading.

(U.S.) A specific provision on high-frequency algorithmic trading has been established under the rules of the Financial Industry Regulatory Authority (FINRA).