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For retail investors, a long wait for algo trading

Shailesh Menon

Brokerages say they're not ready while authorities wave red flags, writes Shailesh Menon

Retails investors in India have long yearned for a crack at algorithm trading which involves use of pre-set computer programmes to execute trades but their experience has been like teenagers who are told they are too young to drive cars.

“Allowing small retail investors to trade using algorithms would be like giving a gun to someone who can't shoot,“ says Nithin Kamath, founder of Bengaluru-based discount broking firm Zerodha.

Zerodha is one of the few stock brokerages that are trying to popularise algorithm trading, albeit cautiously. The brokerage outfit only prefers to give algorithm trading (algo trading) to traders who are experienced in technology, as they are in stock markets.

“We'd like to be sure the person knows a few things about codes and how they affect his trades. We don't want him run to coders for explanation when things go awry,“ Kamath adds. Brokerages like Zerodha has also set trading limits for algo traders ranging between `50 lakh and `1 crore.

Speedy trade execution, accuracy and reduced costs are factors that make algorithm trading popular among investors. It minimises “emotions“ (while investing) and keeps investors on a preset plan. Mechanical failures and software glitches are the biggest disadvantages of algo trading.

In developed markets like the US, more than 90% of the trades (at much higher volumes) are done using algorithms. Also, there are not many restrictions on retail investors using algos to trade.

But the levels of caution exercised by brokers like Zerodha have made algorithms (algos) a preserve of high value clients and institutional investors in India. Algorithm trading constitutes nearly 50% of the overall trading in India. This is negligible considering the moderately low trading volumes in Indian stock markets. If one goes by broking industry estimates, retail algo trading accounts for just about 2% of overall volumes in India.

“We'd love to give algos to our small-ticket clients, but somehow, we feel they're not ready for it,“ says Prasanth Prabhakaran, head of retail broking at IIFL. “The day retail clients stick to pre-decided strategies -and not reset stop-losses too frequently -we'll open algos to small investors.“

In India, brokers (and to some extent the exchanges) intend to safeguard investors from losing money by using inappropriate and complex algo strategies. Several market-savvy retail investors view this stance as “paternalistic“ and discriminatory. They feel they are being elbowed out by institutional investors who use speedy intelligent algos to log more profitable trades.

Their concerns get accentuated when regulatory bodies like Sebi aim their efforts at bringing about parity among algo users -which are mainly institutional investors. For instance, the regulator is now thinking of setting up `speed bumps' to control speed at which high frequency trades take place. This is intended to bring about a level playing field for traders using algorithms.

Limiting The Reach

Regulations concerning algorithm trading in India are centered on risk management -and not much on technology, as is the case in developed markets. The term `algo trading,' in itself, is not very clearly defined; therefore no one really knows what constitutes an algo. One is never sure whether `macros,' semi-automatic trading software and one-touch binary options are classified as algos or non-algos.

“There's a lack of clarity on several fronts; even now brokers are not sure if they can give algorithm trading to small retail investors en masse,“ says Praveen Gupta, CEO of Symphony Fintech, an automated trading systems provider.

Stringent approval processes have also restricted the spread of algorithm trading among retail investors. Sebi mandates all `direct execution' algo factors (strategies) to be vetted and approved by NSE before putting them to use. Clients who seek complex direct execution algos are required to be an `authorised partner' (like a sub-broker) of the broker.

Red Tape

Too “Regulatory changes apart, the existing approval process (of algorithms by exchanges) is rigorous and very comprehensive. Several rounds of testing, demos and mock participation are carried out before approving any algos,“ says Mr Kunal Nandwani, founder of fin-tech firm U Trade Solutions.

According to brokers, exchanges take a lot of time to approve direct execution algos of retail investors as these are uploaded on investors' personal servers. Since the algo (programmed strategy) is stationed in investors' computers, brokers or even the exchange have limited control over trades executed by investors with direct execution capabilities.

Exchanges are more comfortable approving algo strategies housed in broker platforms, where investors need to adhere to brokers' risk filters and trading rules. Savvy investors, however, do not like this arrangement as customised algo strategies (stored on brokers' servers) could be shared with other clients by unscrupulous brokers.

"A level playing field should be brought between traders and investors. It's very unfair to keep small retail investors -consciously or otherwise -away from such trading options," says Gupta, adding, "of course, these investors should know what they're doing when they indulge in automated trading."

Within algo trading, only high frequency trading (speed trading) has become popular in India. Even institutional investors have not graduated to more complex and intelligent investment strategies, according to industry insiders.


Mode Of Trading In Cash Market (June 2016)

MODE	% OF VOLUME
Non Algo	41.98
Algo	16.45
DMA	0.5
Co-location	22.32
Internet Based Trading	12.81
Mobile	3.32
Smart Order Routing	2.63

Source: NSE