

# Securities Broker/Dealer - China

## Potential impact from the quant tightening in China

Industry Overview

### Eyes on quants

The CSRC (China Securities Regulatory Commission) suspended Lingjun, one of the largest quants funds on the A-share market, from trading for 3 days due to its “abnormal trading” on 19<sup>th</sup> Feb, the first trading day after the Chinese New Year (CNY) holiday. According to the regulator, Lingjun dumped RMB2.6bn worth stocks in the first minute after market open, leading to a small-scale market crash which recovered later. As we mentioned in our report, the regulators have been closely monitoring quants and high frequency quant strategies since Aug 2023 and the tightening measures on quants are one of the policies to stabilize the market, together with other measures, like IPO suspension and short lending tightening.

### Why quants suffered?

A popular alpha strategy among quants in a weak A-share market in 2023 was to focus on short-term long positions in micro-caps, while hedging with short positions stock index futures (IC/IM which are linked to CSI500/1000 were the most common ones). In Jan-Feb 2024, a series of events, including Snowball knock-ins, regulatory tightening on stock lending/DMA with restrictions on net selling and National Team’s support in SHSZ300/CSI500/CSI1000 ETFs, have led to panic selling and liquidity crunch in these micro-caps as quants raced to switch positions to larger caps with index-inclusion. Previously crowded trades have led to stampede among micro-caps in the last trading week prior to the CNY, some quants have recorded largest weekly drawdown in history.

### How does regulators view the role of quants?

Based on the recent measures on quants, including restrictions on DMA/futures/stock lending, we reckon that regulators have mixed views on quants. The views though are tilted more towards negative in our view, with the regulators regarding quants strategies as one of the key reasons of market slump. They also view that quants tends to win over the positive side when regulators try to stabilize the market. Quants and high frequency trading are likely to strengthen market momentum and regulators usually choose to limit their roles in a bear market. Quant strategies with the extensive use of leverage may be further tightened – DMA strategies with 2-4x leverage have already been regulated at end 2023. However, we do not think quants strategies would be completely prohibited, but more likely, strategies would likely be renewed, and quants products would re-emerge in new forms. In addition, quants funds are a key liquidity provider in the market, esp. for small-cap stocks.

### Near-term impact on the market

After DMA de-leverage and quants stampede pre-CNY holidays, the correlation between micro-caps and other A-share indices has gradually resumed normal in the past 2 trading days. With CSRC’s increased scrutiny on quants and net selling restrictions still in place, small/micro caps represented by CSI2000 should see less selling pressure. Signs of National Team support is also a key to watch.

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