BABEŞ-BOLYAI UNIVERSITY CLUJ-NAPOCA
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DIPLOMA THESIS

Advancing Market Integrity: A Reinforcement Learning Approach to Detect Spoofing and Layering in Algorithmic Trading

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ABSTRACT

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Algorithmic Trading and Market Integrity

The objective of this chapter is to present the terminology required for a better understanding of the main topic of the thesis, specifically providing a brief theoretical insight on algorithmic trading. Furthermore, we explore how *spoofing* and *layering* are performed, and how such manipulative tactics can deeply impact financial markets.

2.1 Introduction to Algorithmic Trading

Undoubtedly, the landscape of modern financial markets has undergone major transformations in recent decades due to the widespread adoption of algorithmic strategies. In general, *algorithmic trading* (or widely referred to as *automated trading* or *black-box trading*) represents the execution of trades at precise moments by leveraging the use of computer programming. Put another way, algorithmic trading improves the *liquidity* of markets by ruling out the involvement of human emotions and execution delays specific to *traditional market-making*. In their seminal work, Hendershott & Riordan (2013) provide a comprehensive examination of algorithmic trading and its implications for market liquidity, by studying the impact of algorithmic trading strategies on market dynamics [HR13].

In the context of market manipulation, we aim to focus specifically on *high-frequency trading* (HFT), which is characterised by speedy execution, when it comes to buying or selling securities. HFT is applied not only in stock markets, but in exchanging stock options and futures as well [Dur10].

Thanks to recent advancements in hardware development and the impact of *Field Programmable Gate Arrays* (FPGAs) on ultra-low latency, even a couple of *nanoseconds* could make the difference between *profit* and *loss*.

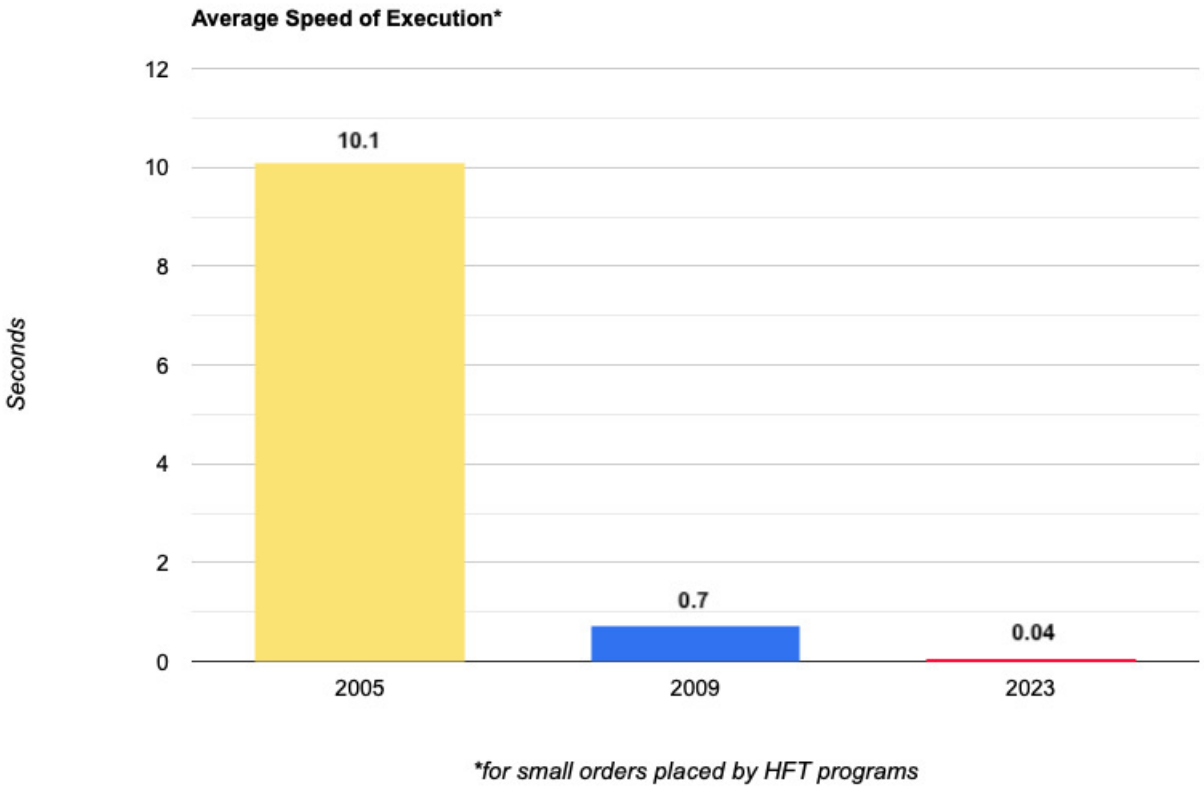

Figure 2.1: The average speed of execution for small orders in HFT has come to the realm of nanoseconds thanks to the development of ultra-low latency systems.

Given how ultra-low latency adversely affects market dynamics, we now introduce the fundamental concept in HFT: the *order*. Put succinctly, a trade cannot occur without a previously placed order to initiate it.

In his article "Limit Order Books", Martin D. offers an ample and insightful definition for orders, as well as for fundamental terms that are frequently used in the financial literature [MDGH13]:

Definition 2.1.1 (Order) *An order $x = (p_x, \omega_x, t_x)$, submitted at time t_x, with price p_x, and size $w_x > 0$ (respectively, $w_x < 0$), is a commitment to sell (respectively, buy) up to $|\omega_x|$ units of the traded asset at a price no less than (respectively, no greater than) p_x.*

Definition 2.1.2 (Bid Price) *The bid price at time t is the highest stated price among active buy orders at time t,*

$$b(t) := \max_{x \in B(t)} p_x. \tag{2.1}$$

Definition 2.1.3 (Ask Price) *The ask price at time t is the lowest stated price among active sell orders at time t,*

$$a(t) := \min_{x \in A(t)} p_x. \tag{2.2}$$

Definition 2.1.4 (Mid Price) *The mid price at time t is*

$$m(t) := [a(t) + b(t)]/2. \tag{2.3}$$

Definition 2.1.5 (Bid-Ask Spread) *The bid-ask spread at time t is*

$$s(t) := a(t) - b(t). \tag{2.4}$$

It is important for an investor to know how to leverage the placement of two major order types in stock trading: *market orders* and *limit orders*.

A *market order* involves *buying* or *selling* a security immediately, the price of the transaction being strongly linked to the time of its execution (different from submission). This implies that the price at submission time might (at most times) deviate from the price at execution time; price remains unchanged only when the *bid/ask* price is exactly at the last traded price. Therefore, with immediate execution, market orders are more aggressive - volatility increases drastically, especially for investments with fewer shares on the market or smaller trade volumes.

Pushing the market in the opposite direction, *limit orders* (sometimes known as *pending orders*) are characterised by total price control, coming with a specific set of instructions on the execution of the trade. Investors specify the maximum *bid* price or the minimum *ask* price for their stocks. The brokerage will execute the order only if the price of the financial instrument aligns with the specified bounds; otherwise, the order will be left *unexecuted*. Interestingly, the conditions imposed in limit orders can even lead to partial orders (only a part of the shares will be traded), as the price of the investment can modify *mid-order*. In the next sub-chapter, we will delve into how the less-aggressive nature of limit orders is exploited to produce "artificial" shifts and influence the stock markets.

Since market manipulation most commonly occurs via limit orders, as previously indicated, our subsequent discussion will elaborate on basic order dynamics: how limit orders are stored, processed and amended. Most exchanges make use of *Central Limit Order Books* (CLOBs), or simply known as *Limit Order Books* (LOBs), to execute limit orders. LOBs are transparent, real-time, anonymous, and low-cost-in-execution systems that utilise *order books* and *matching engines* to map bid/ask orders of investors based on *price-time* priority. Considering a financial instrument which investors place orders for, the best market consists of mapping the highest bid offer to the lowest ask offer.

Martin D. offers the following definition for an LOB [MDGH13]:

Definition 2.1.6 (Limit Order Book) *An LOB $L(t)$ is the set of all active orders in a market at time t.*

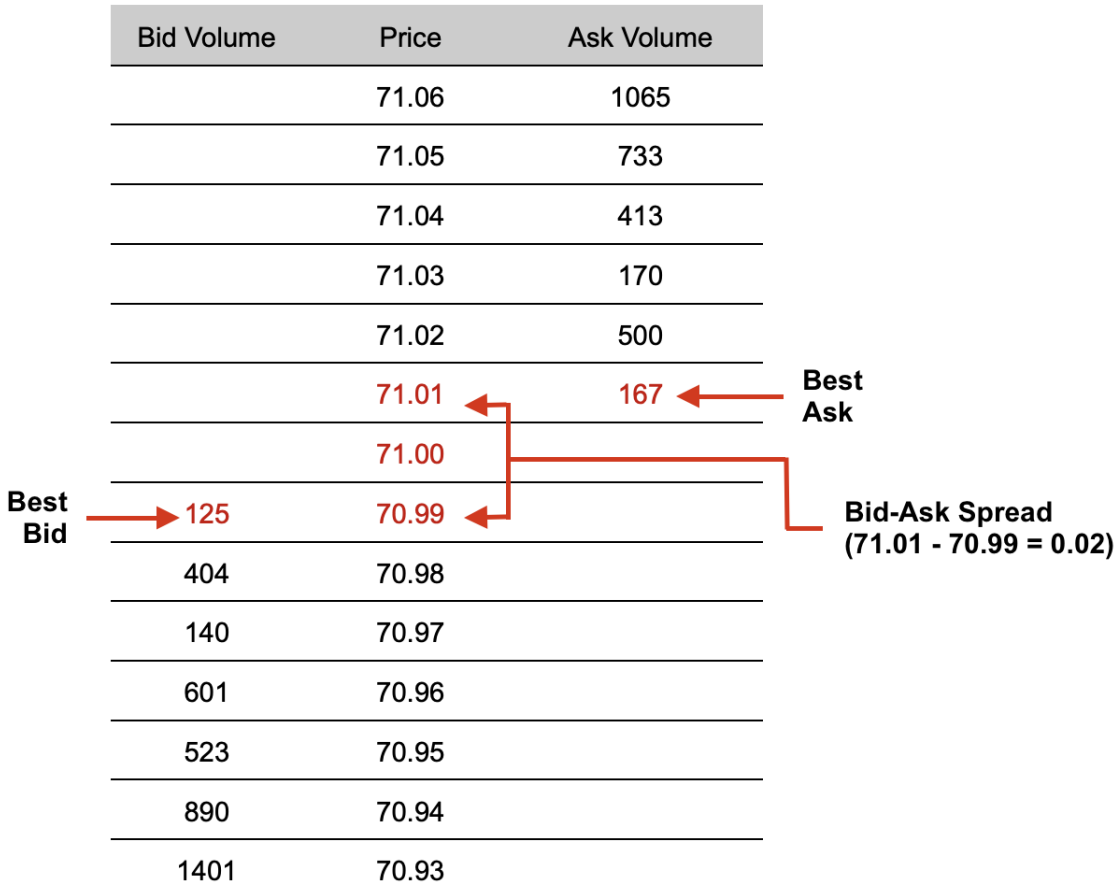

Figure 2.2: Graphical example of a 15-level deep LOB on a particular financial instrument. It depicts how traders judge liquidity and how they arrive at the bid-ask spread.

We continue with defining three crucial concepts for understanding CLOBs: *liquidity*, *price discovery*, and *depth of market*.

Liquidity refers to the degree to which a security can be easily traded in the market at a price reflecting its intrinsic value. Put another way, liquidity is the efficiency of converting an asset into ready cash without affecting its market price - the most liquid security is cash itself.

The most standard way of measuring liquidity is using the *current ratio* formula:

Definition 2.1.7 (Current Ratio) *The current ratio is a liquidity ratio measuring the capability of an investor of having enough resources to meet their short-term obligations:*

$$current\_ratio = \frac{current\_assets}{current\_liabilities}. \tag{2.5}$$

Price discovery denotes the (explicit or deduced) process in which buyers and sellers establish the fair price of a financial instrument in the market, at a given time.

It implies conducting market research analysis, by evaluating supply and demand, environmental, geopolitical and socioeconomic factors.

Depth of Market (DOM) refers to the volume of orders pending to be transacted for a particular security at different price levels - it is the overall level (or breadth) of open orders.

A large order can significantly impact DOM and liquidity. If a large buy order enters the market, it can exhaust the available sell orders at lower prices, increasing the price as it fulfills higher-priced sell orders. Conversely, a large sell order can fulfill all the buy orders at higher prices, driving the price down as it starts matching with lower-priced buy orders. This impact on price through the supply and demand balance is a direct outcome of the market's liquidity and depth.

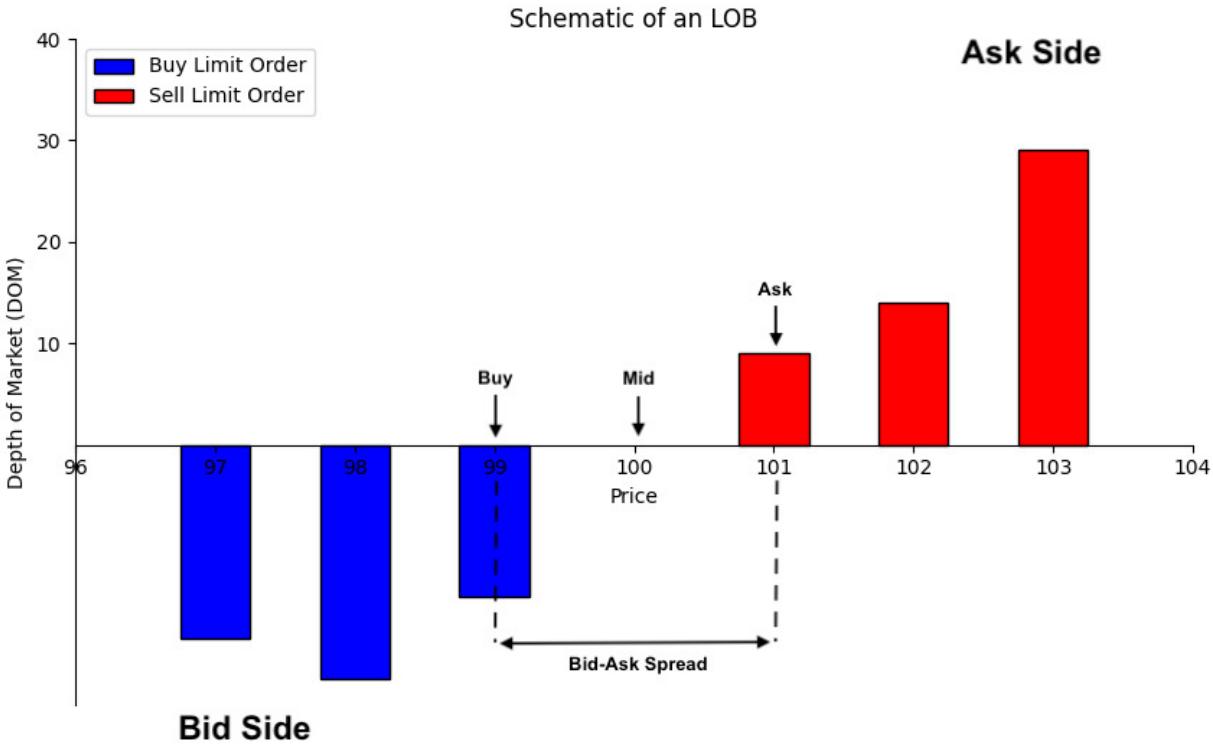

Figure 2.3: Schematic of an LOB

While we already covered the fundamentals of order placement, it is essential to acknowledge the mechanisms for order modification and cancellation in an LOB. In terms of *modification*, traders are generally allowed to update the limit price or the quantity of an existing order via the trading platform of the exchange. Modifications are generally permitted until the execution has begun, depending on the trading platform or exchange. For instance, if a buy limit order is partially filled,

the quantity or price may be adjusted for the remaining unfilled portion. As a consequence, after an order has been modified, the investor should be aware about the impact of such operation on the LOB - the priority of the order in the LOB might be affected. For example, if the investor increases (respectively, decreases) the buy (respectively, ask) price of the security, the order might shift its position in the order book, as it becomes more competitive. Changing the quantity of an order could also impact both the priority in the LOB and the likelihood of execution.

Order *cancellation* in trading can occur for various strategic reasons. Cancellation for manipulative intents will be covered in a later chapter; however, traders might *legitimately* cancel limit orders because of shifting market conditions (e.g. news events affecting stock prices, market moving against their strategy). The impact of cancellations on LOBs includes the change in available liquidity, bid-ask spread and perceived market depth.

LOBs can be classified into different *levels*, based on the amount of information they provide:

1. **Level 1** - It encapsulates basic market data, such as:
    - *Bid price*;
    - *Bid size*;
    - *Ask price*;
    - *Last price*;
    - *Last size*.
2. **Level 2** - Additionally to Level 1 data, it doesn't provide just the highest bid and lowest offer, but also bids and offers at other prices:
    - *Highest bid prices*;
    - *Bid sizes*;
    - *Lowest ask prices*;
    - *Ask sizes*.
3. **Level 3** - It provides even deeper information than Level 2 data. Level 3 data refers to non-aggregated bids and asks placed by individual market makers. A Level 3 data feed would include every individual bid and ask, including *time series*.

LOB snapshots can be procured from various stock & crypto exchanges or trading platforms, via *WebSocket feeds* (for real-time data), or *REST APIs* (for historical data). The implementation proposed in this thesis will make use of *Level 3 LOB data*, to take full advantage of temporal information.

2.2 Challenges in Market Integrity: Spoofing and Layering

With the rise of algorithmic trading and the automation of financial markets, there is no doubt that the market becomes more and more exposed to major risks of fraud and exploitation. Affecting market integrity takes multiple forms, including market manipulation, insider trading, and short selling, all of them causing ample market destabilization due to their complex and ever-evolving nature. This thesis targets the challenges brought by market manipulation, particularly by two of its widely spread forms: spoofing and layering.

Market manipulation is defined as a set of "actions intended to cause an artificial movement in the market price, so as to make a profit or avoid a loss" [AAD+16]. Therefore, it is easy to justify why such cases of misconduct erode the confidence of investors and challenge the perception of market stability.

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act") defines *spoofing* in the realm of algorithmic trading as "bidding or offering with the intent to cancel the bid or offer before execution" [Dod10]. A trader places multiple large limit orders on a security with no intention of executing them. This is performed with the aim of artificially decreasing (respectively, increasing) the price of an asset, with the later intent of placing the actual buy (respectively, sell) order after cancellation, giving the false impression to other traders that the security is "on-demand".

Layering is a particular case of spoofing, which consists of placing multiple *non-bona fide* orders at *multiple price tiers*, in contrast to spoofing, where orders are entered only at the top of the order book.

Spoofing and layering often cause extreme volatility and rapid price movements. In such cases, they largely contribute to flash crashes. A *flash crash* is an event in electronic markets, where prices of a financial instrument *drop* dramatically, but then they immediately *rebound*. Flash crashes are *sudden* and short-lived: at the end of the day, it appears as if the crash had never happened.

While some methods are relatively straightforward (e.g. spreading *fake news*), spoofing and layering, take more subtle forms, and the methods used by malicious investors are constantly evolving. Additionally, in some cases, it is difficult to decide whether an investor has the intention of causing harm (e.g. a company buying its own shares to rise their price). This leads to the complexity of developing an efficient system that detects spoofing and layering in all of its shapes, and not misclassify peculiar cases of legal practices.

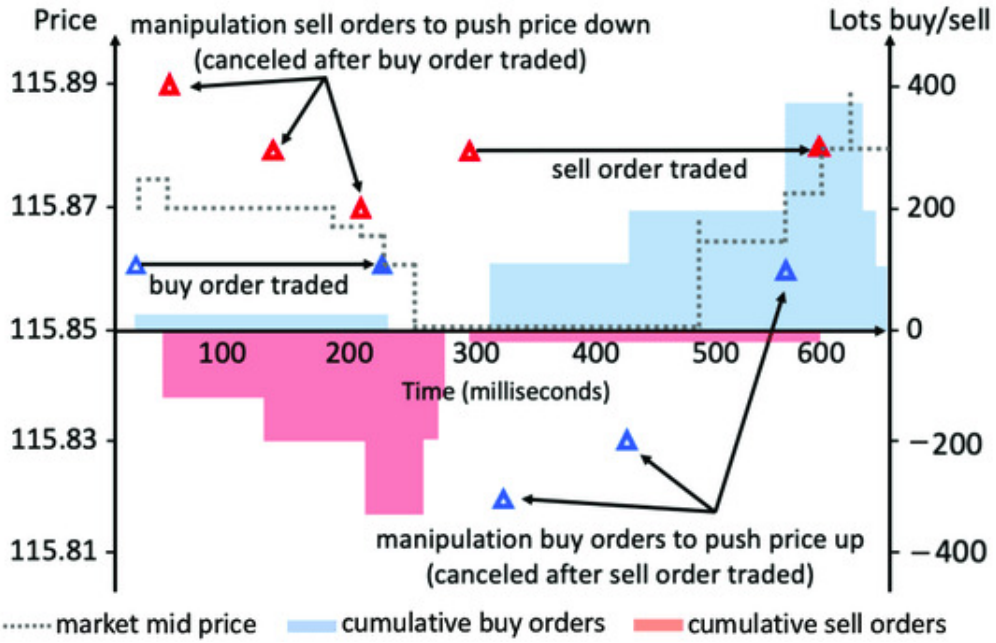

Figure 2.4: Illustrating an example of spoofing. Source: UK Financial Conduct Authority Final Notice 2013 [WHVW21]. "0.6 s, demonstrating how quickly and effectively such manipulation behavior can affect the market and profit from spoofed belief."

2.3 Case Studies of Notable Market Events

In his seminal work, *Spoofing, Market Manipulation, and the Limit-Order Book*, J. Montgomery highlights two notorious cases involving spoofing and layering allegations [Mon16], with those that pleaded guilty for the criminal actions being sentenced to up to *five years of imprisonment* and paying forfeits of as much as *US$300.000*.

One pivotal event revolves around Michael Coscia, who in November 2015 became the first person convicted of spoofing, under the *Dodd-Frank Act*. M. Coscia placed large "bait" orders for futures contracts on various commodities, through exchanges from the United States and the United Kingdom. This lead to a net profit for Mr. Coscia of *US$1.4 million* over a span of ten weeks as part of six attempts of spoofing.

In the most notable case of layering, Aleksandr Milrud lead a complex scheme for trading US securities. Mr. Milrud recruited and shared profits with online traders from China and Korea, who placed and then quickly cancelled HFT buy and sell orders at multiple price tiers, yielding net profits of as much as *US$600,000* in a day. This accumulated in net monthly profits between *US$1 million* and *US$50 millions*.

As part of our study, we aim to analyse LOB data from flash crashes, due to the high frequency of spoofing and layering attempts during such events. Specifically, we conduct our research on the flash crash of *LUNA*, from May 2022. Over a span of

just three days, *Terra*, the third-largest cryptocurrency ecosystem following Bitcoin and Ethereum, experienced a dramatic collapse, erasing *US$50 billion* in market valuation [LMS23].

2.4 Ethical and Legal Considerations

As highlighted in the legal cases presented in the previous chapter 2.3, the realm of financial trading is not only governed by economic principles, but also operates within a framework of ethical and legal standards. It is essential to implement and continually revise regulations to diminish the systematic losses produced by information asymmetry sourced from market manipulation.

In *"Principles of Financial Regulation"*, John Armour covers multiple aspects regarding the regulation of market manipulation, both in the European Union and the United States [AAD+16]. The integrity of financial markets hinges on the equitable treatment of all market participants. Unethical practices, such as market manipulation through spoofing and layering, undermine this fairness and can lead to significant distortions in market dynamics. Moreover, the lack of transparency in certain trading activities poses a threat to the trust essential in financial markets. This is particularly critical for retail investors, who might lack the resources to identify and navigate deceptive market practices effectively.

As mentioned in subchapter 2.2, legal frameworks, such as the *Dodd-Frank Act* (adopted in the US), play a vital role in regulating market activities and deterring unethical behavior. The legislation in both EU and US is designed to prevent market manipulation and promote a transparent trading environment. As noted in a report by Steel Eye [Steon], market manipulation in US rules under multiple laws, including:

- *Commodity Exchange Act (CEA) (Section 4c(a)(5)(C))* [CEA13];
- *Securities Exchange Act of 1934 10(b)* [SEA34];
- *FINRA Rule 2020* [FIN08].

Regarding the UK and EU legislation, the *Market Abuse Regulation* (MAR) [MAR14] encompasses regulations related to insider trading, the illegal disclosure of privileged information, and the manipulation of markets.

Chapter 3

Reinforcement Learning and Optimization Methods

This chapter aims to cover fundamental *Reinforcement Learning* (RL) concepts that can be applied in high-frequency trading, specifically in market manipulation detection. We will dive deeper into how *Proximal Policy Optimization* (PPO) is applied to potentially solve market integrity issues.

3.1 RL Mechanisms: Markov Decision Processes, Policy Gradients and Actor-Critic Methods

It is no secret that in recent years, the interest in *Machine Learning* (ML) renewed thanks to exponential advancements and its extension to a broad range of fields. In less than a decade, ML has become an integrating part of almost every aspect of our lives: education, business & marketing automation, our social and personal life, and ML will only increase its potency in the future, especially with the recent rise of *Generative AI* (GenAI) and the race for developing the first instance of *Artificial General Intelligence* (AGI). As of the time of writing, creating AGI is the primary objective of pioneering AI research companies such as *OpenAI* [Ope24], *Google DeepMind*, and *Anthropic*.

The three main ML *paradigms* are: *Supervised Learning* (SL), *Unsupervised Learning* (UL), and *Reinforcement Learning* (RL). This chapter solely focuses on fundamental concepts of RL, as the only methods that we will use in the development of our detector are based on reinforcement. We will now proceed with covering the most essential terms and concepts in RL.

The term *"reinforcement"* originates from research conducted on animal behaviour, in the context of adaptive learning and experimental psychology - in the occurrence of an event and the proper relation to a response, the goal is to increase the prob-

ability of that specific response occurring again in the same situation [Kim61]. The same principles are transposed in *Reinforcement Learning* (RL), an area of Machine Learning, described as "the science of decision making" through *optimal control*: an agent must take a suitable action to maximize cumulative rewards for achieving the desired result. In contrast to supervised learning, where the key result is given by labeling training data, the reinforcement agent is bound to adapt and learn from its experience, in the absence of a training dataset.

When it comes to how the behaviour of the agent is constructed through rewards, there are two types of reinforcement: *positive* and *negative*. In *positive reinforcement*, the occurrence of an event, being performed due to a specific behaviour, increases the frequency of that particular behaviour. Reinforcement with a positive effect allows maximised performance, and sustains long-term changes. An overuse of positive reinforcement produces an overload of states, thus diminishing the results.

In contrast, *negative reinforcement* highlights the idea of refining the behaviour of an agent through stopping or avoiding negative conditions. Reinforcement with negative effect builds up the bare minimum structure for an agent to work, providing defiance to a minimum standard of performance.

The environment in which an agent is placed is usually modeled as a *Markov decision process* (MDP), due to the use of *dynamic programming* (DP) techniques [vOW12]. The main difference between DP and RL is that the latter does not assume information about the mathematical model used in the MDP, but they rather target large MDPs where exact models become infeasible [EL22].

Definition 3.1.1 (Markov Decision Process) *An MDP is a discrete-time stochastic control process for decision making in systems that are partly random, and partly under the control of the decision maker.*

We can now translate the definition of an MDP in the context of an RL model. It is generally represented as a *4-tuple* (S, A, P_a, R_a), where:

- S is a set of *environment* and *agent states*;
- A is a set of actions of the agent, called the *action space* (alternatively, A_s is the set of actions available from state s);
- $P_a(s, s') = Pr(s_{t+1} = s' \mid s_t = s, a_t = a)$ is the probability that action a in state s at time t will lead to state s' at time $t + 1$;
- $R_a(s, s')$ is the immediate reward (or expected immediate reward) received after transitioning from state s to state s', due to action a.

The state and action spaces may be finite or infinite. Processes with countably infinite state and action spaces can be simplified into ones with finite state and action spaces [Wro84].

We are now able to introduce the crux in RL, when it comes to the strategy utilised by the agent in pursuit of its goals: the *policy*.

Definition 3.1.2 (Policy) *A policy function π is a (potentially probabilistic) mapping from the perceived state space (S) of the environment to its action space (A):*

$$\pi : A \times S \to [0, 1]$$
$$\pi(a, s) = \Pr(A_t = a \mid S_t = s)$$

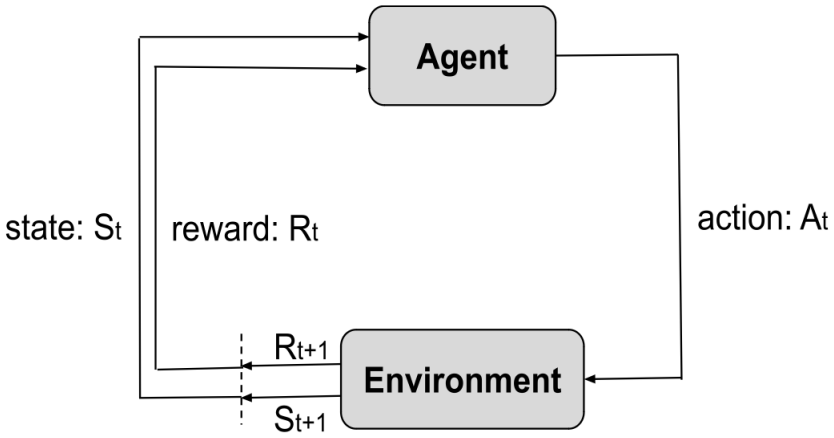

Figure 3.1: The Canonical Agent-Environment Feedback Loop. Basic algorithm for an RL approach: at each time t, the agent receives the current state S_t and reward R_t. It then picks and sends to the environment an action A_t from the set of available actions. The environment moves to a new state S_{t+1} and the associated reward R_{t+1} is computed. The aim of the agent is to learn a policy that maximizes the expected cumulative reward.

Consequently, the network that transforms input frames into output actions is called *"policy network"*. This allows us to finally consolidate the theoretical basis that underlies the methodology of our thesis: one of the simplest ways to train a policy network is given by control algorithms entitled *"policy gradients"*. All MDPs have at least one *optimal* policy.

Definition 3.1.3 (Parameterised Policy Objective) *The objective is to maximise the expected reward, following the imposed parameterised policy:*

$$J(\theta) = \mathbb{E}_\pi[r(\tau)] \tag{3.1}$$

A solution method, targeting the maximization problem, that is widely recog-

nized in the ML literature is *Gradient Ascent* (respectively, *Descent)*. In gradient ascent, an update rule is used for iterating through the parameters:

$$\theta_{t+1} = \theta_t + \alpha \nabla J(\theta_t) \tag{3.2}$$

The challenge brought by policy gradients is how we determine the gradient of the objective defined at 3.1. It is known that integrals are slightly inefficient in computational setting, so a workaround needs to be defined. This consideration lies at the base of the *Policy Gradient Theorem*.

Definition 3.1.4 (Policy Gradient Theorem) *The derivative of the expected reward is given by the expectation of the product between the reward and the gradient of the log of the policy π_θ:*

$$\nabla_\theta \mathbb{E}_{\pi_\theta}[r(\tau)] = \mathbb{E}_{\pi_\theta}[r(\tau) \nabla_\theta \log \pi_\theta(\tau)] \tag{3.3}$$

One of the biggest challenges in the realm of reinforcement learning has been given by the *Exploration vs. Exploitation Dilemma*.

Exploration refers to the agent's action of trying new strategies that lead to better long-term rewards. It's akin to venturing into the unknown; the agent experiments with different actions and observes their outcomes. Exploration is crucial in the early stages of learning or in dynamically changing environments where previous knowledge may become outdated.

Exploitation, on the other hand, involves leveraging the knowledge the agent has already acquired to make decisions that yield the highest immediate reward. When exploiting, the agent selects the best-known action based on existing information, favoring short-term gains.

The trade-off comes into play, since both actions cannot be performed simultaneously and need to be balanced. If an agent explores too much, it may miss out on known rewards. Conversely, if it exploits too often, it may overlook better options that it hasn't discovered yet.

Balanced strategies have been developed in an attempt to solve the dilemma, one of the most known being the *ϵ-greedy method*, where the agent explores randomly with probability ϵ and exploits with probability $1 - \epsilon$. As learning progresses, the value of ϵ can be reduced, shifting the balance from exploration to exploitation as the agent gains more knowledge.

With this in mind, we are now able to contour a couple of general RL tenets that are pivotal to Proximal Policy Optimization (PPO), which will be explained thoroughly in the next subchapter.

Temporal Difference (TD) Learning is an essential concept in reinforcement learning that combines ideas from *Monte Carlo* methods and *Dynamic Programming* [vOW12].

It allows an agent to learn directly from raw experience without a model of the environment's dynamics. As an agent interacts with the environment, TD Learning updates the value of states in a way that the expected future rewards are estimated more accurately over time.

Moreover, *Q-learning*, a widely known TD Learning algorithm, is particularly notable for its ability to compare the expected utility of the available actions without requiring a model of the environment [WD92]. This value-based method has been instrumental in developing Proximal Policy Optimization (PPO), which further refines the policy optimization process. At the heart of TD learning and Q-learning stand *value functions*.

Considering the Canonical Agent-Environment Feedback Loop scheme from 3.1, we can define *value functions* as a measure of the expected long-term reward attainable in certain conditions defined by the states and action space. There are two types of value functions in RL: *state-value* and *action-value*. By the end of this subchapter, we will explore the relation between the two and how they lead to informed and optimal decision-making, required by PPO.

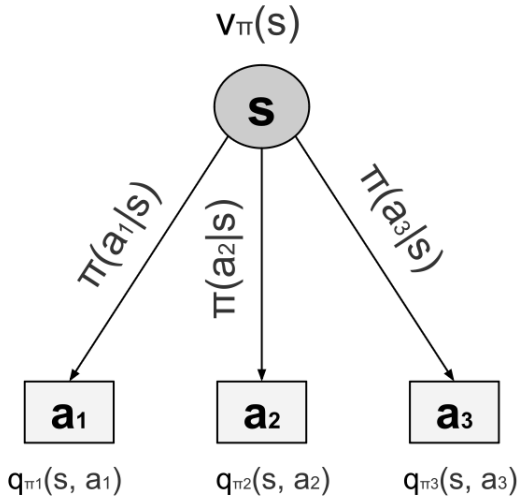

Figure 3.2: Value functions in the context of the action space $A_s = \{a_1, a_2, a_3\}$, generated by state s. Each action a_i is taken with probability $\pi(a_i|s)$.

Definition 3.1.5 (State-Value Function) *The state-value function denotes the expected cumulative reward, starting from state s, following policy π:*

$$V_\pi(s) = \mathbb{E}_\pi \left[\sum_{t=0}^{T-1} \gamma^t r_t \mid s_t = s \right] \tag{3.4}$$

where γ is the discount factor that determines how long the return depends on future rewards.

Alternatively, the total cumulative reward at timestep t can be written using the goal G as shown below [Gor17]:

$$V^{\pi}(s) = E_{\pi}\{G_t \mid s_t = s\} \tag{3.5}$$

Definition 3.1.6 (Action-Value Function) *The action-value function denotes the expected cumulative reward, starting from state s, following policy π, taking action a:*

$$Q_{\pi}(s, a) = E_{\pi}\left[\sum_{t=0}^{T-1} \gamma^t r_t \mid s_t = s, a_t = a\right] \tag{3.6}$$

In terms of goal G, the action-value function becomes [Gor17]:

$$Q^{\pi}(s, a) = E_{\pi}\{G_t \mid s_t = s, a_t = a\} \tag{3.7}$$

The relationships between $V_{\pi}(s)$ and $Q_{\pi}(s, a)$ (in terms of each other), in a stochastic policy π, are given by the following Bellman equations [Gor17]:

$$V^{\pi}(s) = \sum_{a \in A} \pi(a \mid s) * Q^{\pi}(s, a)$$
$$Q^{\pi}(s, a) = \sum_{s' \in S} P(s' \mid s, a)\left[R(s, a, s') + \gamma V^{\pi}(s')\right]$$

Definition 3.1.7 (Advantage Function) *The advantage function, $A^{\pi}(s, a)$, quantifies how much better it is to take a specific action a in state s over randomly selecting an action according to the policy's probability distribution. Mathematically, it's defined as $A^{\pi}(s, a) = Q^{\pi}(s, a) - V^{\pi}(s)$.*

The important role the advantage function plays in PPO is that it provides a relative measure of the value of actions, guiding the policy update process.

Another staple in modern RL frameworks is given by *Actor-Critic Methods*. These are, in fact, *policy gradients* applied in *TD learning*. Konda & Tsitsiklis describe the *"actor"* component of the model as responsible for selecting actions based on a policy that is directly parameterized, while the *"critic"* assesses the actions taken by the actor by computing a value function [KT00].

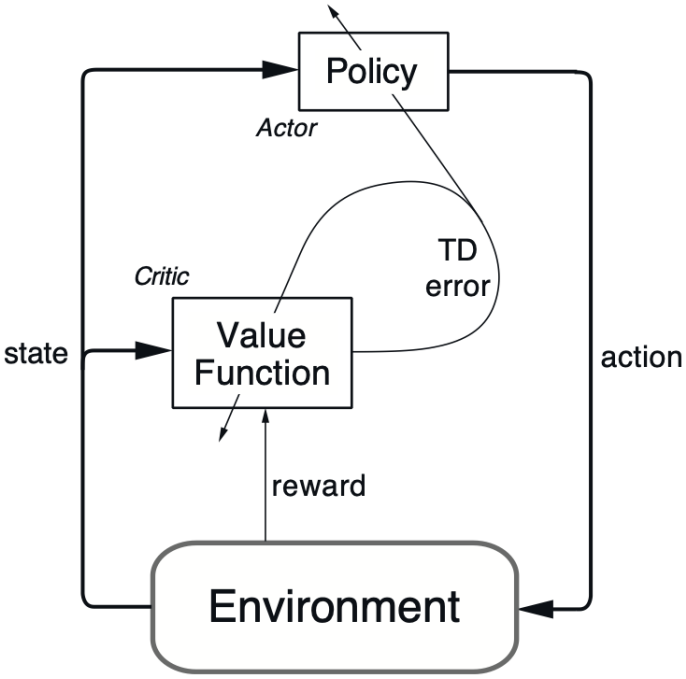

Figure 3.3: The actor-critic architecture. Source: *Reinforcement Learning: An Introduction (Sutton & Barto, 2018)* [SB18].

Having established the foundational concepts of Reinforcement Learning, such as value functions and Temporal Difference Learning, we are now well-positioned to transition to a more focused examination of *Proximal Policy Optimization* (PPO) in the upcoming subchapter.

3.2 Proximal Policy Optimization (PPO)

Proven successful on a wide variety of tasks from robotic control to surpassing grandmasters at multiple strategy games, *Proximal Policy Optimization* (PPO) is a *deep reinforcement learning* algorithm designed by OpenAI in 2017. Since then, it became the default RL algorithm used by the AI research company, due to its simplicity and outstanding performance [Ope17].

The road to success in RL is often marked by major challenges. One potential issue arising is that training data is itself dependent on the current policy, since agents generate it by interacting with the environment, rather than relying on a static dataset, as it is the case for supervised learning. This implies that data distributions of observations and rewards are constantly updating as the agent learns, leading to major instability in the whole training process. Another problem frequently encountered is that RL approaches suffer from a very high sensitivity to *hyperparameter tuning*.

To address these issues, the OpenAI team developed the Proximal Policy Opti-

mization algorithm. The core purpose behind PPO was to strike a balance between ease of implementation, sample efficiency and ease of tuning.

PPO is a *policy gradient method*. Therefore, unlike Deep-Q Network, it does *not* rely on *experience replay* (where transition experiences are stored in a *replay buffer* [RMT17]); instead the agent learns *online*. We now introduce the *Policy Gradient Loss*, (strongly related to 3.3), as defined by Schulman et al. in their seminal work [SWD+17].

Definition 3.2.1 (Policy Gradient Loss) *The Policy Gradient Loss is an expectation that maximizes the log-probability of beneficial actions weighted by their advantage estimates, thereby reinforcing effective behaviors:*

$$L^{PG}(\theta) = \hat{\mathbb{E}}_t \left[\log \pi_\theta(a_t \mid s_t) \hat{A}_t \right], \tag{3.8}$$

where $\hat{A}_t$ is the noisy estimate for the advantage function at timestep t, and π_θ a stochastic policy.

One potential issue arises when gradient descent is repeatedly applied to the same batch of collected experience: hyperparameters may become suboptimally tuned, extending well beyond the range appropriate for data collection, resulting in inaccurate estimates of $\hat{A}_t$. This issue can be circumvented by ensuring policy updates do not significantly deviate from the previous policy.

This idea was widely introduced by Schulman et al. two years earlier [SLA+15], in the development of *Trust Region Policy Optimization* (TRPO). TRPO serves as the foundational algorithm upon which PPO is constructed.

As a result, in TRPO, a *KL constraint* is added to the *"surrogate" objective*, which will block any major deviation in policy updates [SWD+17]:

$$\underset{\theta}{\text{maximize}} \quad \hat{\mathbb{E}}_t \left[\frac{\pi_\theta(a_t \mid s_t)}{\pi_{\theta_{old}}(a_t \mid s_t)} \hat{A}_t \right] \tag{3.9}$$

$$\text{subject to} \quad \hat{\mathbb{E}}_t \left[\mathrm{KL}[\pi_{\theta_{old}}(\cdot \mid s_t), \pi_\theta(\cdot \mid s_t)] \right] \leq \delta. \tag{3.10}$$

We will refer to the surrogate objective as $L^{\text{CPI}}(\theta)$, *CPI* standing for the *conservative policy iteration*. Additionally, we denote the probability ratio $r_t(\theta) = \frac{\pi_\theta(a_t|s_t)}{\pi_{\theta_{\text{old}}}(a_t|s_t)}$. For instance, an action more likely to occur in the current policy than in the old one will have $r_t(\theta) > 1$. L^{CPI} is defined as:

$$L^{\text{CPI}}(\theta) = \hat{\mathbb{E}}_t \left[\frac{\pi_\theta(a_t|s_t)}{\pi_{\theta_{\text{old}}}(a_t|s_t)} \hat{A}_t \right] = \hat{\mathbb{E}}_t \left[r_t(\theta) \hat{A}_t \right]. \tag{3.11}$$

The KL constraint guarantees monotonic improvement and an efficient optimization of control policies in TRPO [SLA+15]. However, the constraint may cause

additional overhead in the optimization process, potentially leading to undesirable training behavior.

Fixing this issue is exactly the essential target PPO managed to achieve. The main goal of the first-order algorithm is to maintain the monotonic improvement of TRPO, while replacing the hard constraint over the surrogate objective (3.10) with a penalty [SWD+17]. This leads to the main objective of PPO, the *Clipped Surrogate Objective*:

$$L^{\text{CLIP}}(\theta) = \hat{\mathbb{E}}_t \left[\min(r_t(\theta)\hat{A}_t, \text{clip}(r_t(\theta), 1-\epsilon, 1+\epsilon)\hat{A}_t) \right], \tag{3.12}$$

where ϵ is a hyperparameter, the first parameter of the *minimum* function is $L^{\text{CPI}}(\theta)$, while the second term aims to adjust the surrogate objective by clipping the probability ratio.

This minimalist, yet efficient approach ensures that r_t remains bounded in the interval $[1-\epsilon, 1+\epsilon]$. The value of the advantage estimate may be positive or negative, thus $\hat{A}_t$ affecting the effect of the main operator:

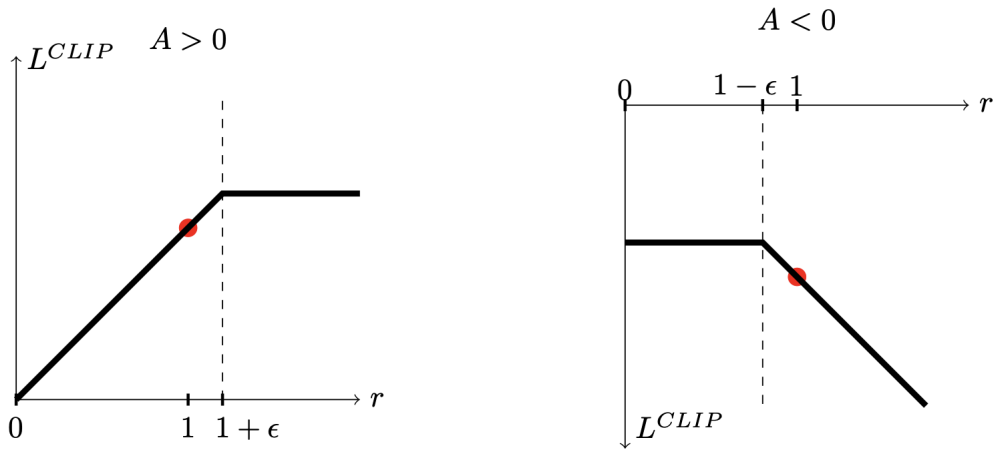

Figure 3.4: One timestep of L^{CLIP} with an advantage estimate of positive (left) and negative (right) value. The first plot showcases a "good" action, more probable after the gradient step. The latter displays the behavior of the agent in the case of undoing the last update policy due to a "bad" action. Source: *Proximal Policy Optimization Algorithms, Schulman et al., 2017* [SWD+17].

We lastly introduce the final training objective in PPO:

$$L_t^{\text{CLIP+VF+S}}(\theta) = \hat{\mathbb{E}}_t \left[L_t^{\text{CLIP}}(\theta) - c_1 L_t^{\text{VF}}(\theta) + c_2 S[\pi_\theta](s_t) \right], \tag{3.13}$$

where c_1 and c_2 are coefficients, S denotes an entropy bonus, and L_t^{VF} is a squared-error loss.

The final objective formula lies at the foundation of the algorithm implementation proposed by Schuman et al. The PPO algorithm makes use of fixed-length trajectory segments, and optimizes the surrogate loss using *minibatch SGD* (or for a

better performance, *Adam*) [SWD+17]:

Algorithm 1 PPO, Actor-Critic Style

for iteration = 1, 2, . . . **do**
  for actor = 1, 2, . . . , N **do**
    Run policy $\pi_{\theta_{\text{old}}}$ in environment for T timesteps
    Compute advantage estimates $\hat{A}_1, \ldots, \hat{A}_T$
  end for
  Optimize surrogate L with respect to θ, with K epochs and minibatch size $M \leq NT$
  $\theta_{\text{old}} \leftarrow \theta$
end for

Source: *Proximal Policy Optimization Algorithms, Schulman et al., 2017* [SWD+17]

3.3 PPO's Edge in Uncovering Market Manipulation

In 2022, Chip Huyen presented in one of her most acclaimed pieces of work, *Designing Machine Learning Systems*, a 2020 survey analysing the large landscape of use cases of enterprise ML (in both internal and external scopes) [Huy22]. We notice that *27%* of enterprise ML applications focus on *"Detecting fraud"*. This demonstrates the feasibility of utilizing ML techniques in our work in detecting forms of financial market manipulation, such as *spoofing & layering*.

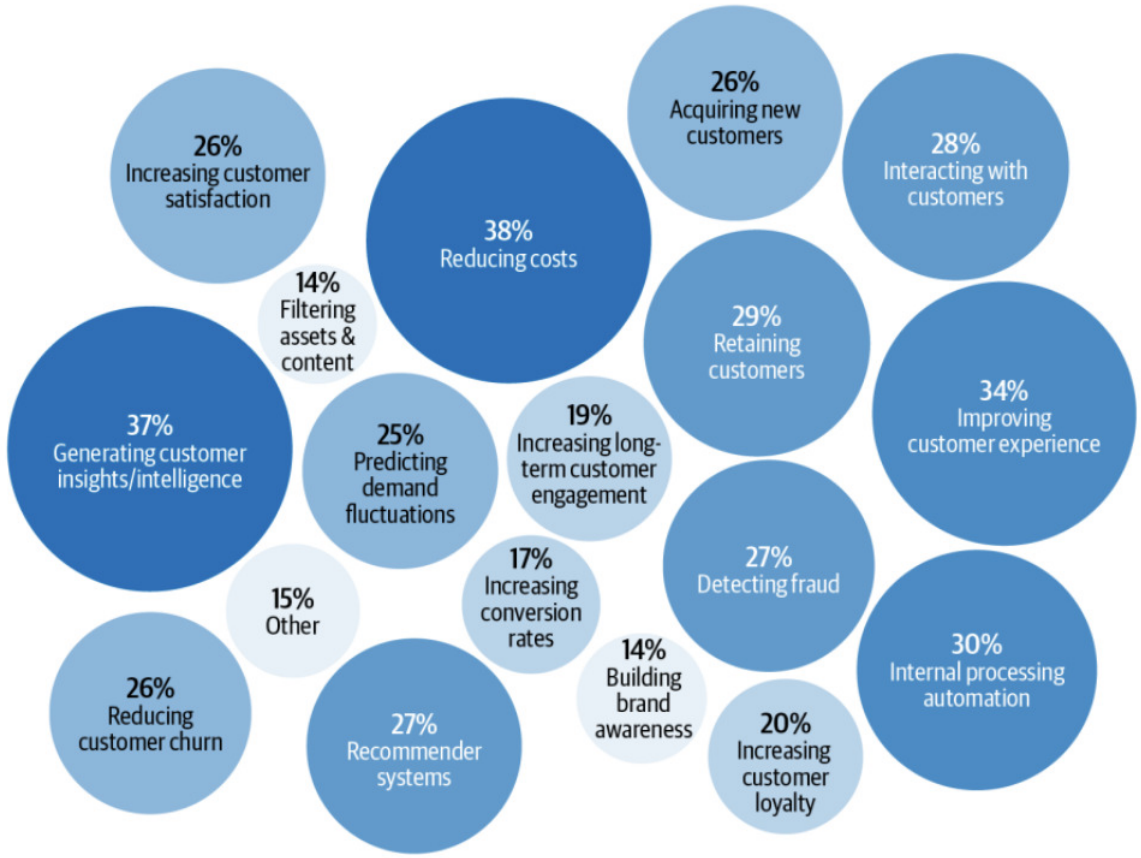

Figure 3.5: 2020 state of enterprise ML. Source: *Designing Machine Learning Systems, C. Huyen* [Huy22].

RL is applied in multiple domains, such as game theory, simulation-based optimization, swarm intelligence, statistics, and multi-agent systems. One obvious characteristic that gives reinforcement learning a major advantage over supervised learning is that, by definition, supervised learning cannot produce an output that is better than human output, since data labelled by humans is involved in the process. This makes RL one of the best candidates in the realm of sports, games, autonomous vehicles, and, most relevant to our thesis, finance. Spoofing and layering are incredibly sophisticated market manipulation tactics, and investors engaging in such practices constantly improve their tactics to avoid detection, making the instances

even harder to be captured by the human eye.

PPO, with its strategic advantage in learning complex policy representations and its robustness against the variance in market data, stands out as a promising candidate for improving market surveillance. The algorithm's adaptability and efficiency in policy updates empower it to discern subtle patterns of fraudulent behavior, offering a substantial leap forward in the ongoing effort to uphold market integrity. In the upcoming chapters, we will explore how PPO principles can be applied to maximize efficiency in detecting financial market abuse through spoofing and layering, during the development of *spoof.io*, the application designed as part of this thesis.

Chapter 4

Literature Survey on Spoofing and Layering Detection

4.1 A Supervised Learning Approach

4.2 Leveraging Unsupervised Anomaly Detection Methods

4.3 Modeling the Order Book Dynamics Using Statistical Physics

Chapter 5

spoof.io: A RL-driven Web-App Tool for Spoofing Detection in LUNA

5.1 Experimental Results

5.2 Application Development

5.2.1 Analysis and Architecture

5.2.2 Design and Functionalities

5.2.3 Implementation

5.2.4 User Guide

5.3 Future Considerations

Chapter 6

Conclusions

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