



New exchange advisory group says fragmentation invites more market abuse.

London Tuesday March 16: The fragmentation of exchange trading and data which has followed from MiFID has substantially increased the potential for market abuses to take place, according to a new exchanges advisory group which has been set up to look at the problem.

Avenues, the Alliance of Independent Advisors to Financial Markets (see below for details), contends that the function of ensuring markets are fair - the surveillance of bids, offers and trades, which was primarily the responsibility of traditional stock exchanges - is now almost impossible to undertake comprehensively given the fragmentation of trading on competing exchanges and trading platforms such as MTFs (multilateral trading facilities), dark pools, systematic internalisers and Over The Counter trading.

In 2005 the Market Abuse Directive (MAD) came into effect prohibiting insider trading and market manipulation across the EU. As well as insider trading, MAD identifies six other classes of market abuse. Similar prohibitions are in place outside the EU. However, MiFID, implemented in 2007, facilitated competitive platforms without fully addressing the surveillance issue. As a result no single exchange now sees all the activity on any given stock for which they are responsible. MTFs do not invest in comparable surveillance infrastructures and internal broker-dealer crossing networks are in effect unregulated in MAD terms. In summary MiFID has legalised cross border trading while leaving market surveillance national.

As an example, Avenues monitored trading in Vodafone on a random week in mid-February. The London Stock Exchange carries out surveillance on the activity in Vodafone transacted on its platform, but during that week it saw less than 33 per cent of the total trades, with some 18 per cent being done on MTFs and almost 50 per cent in dark pools, OTC, or on systematic internalisers.

Steve Leegood of Avenues explained, "In that one stock in one week 800 million shares worth almost £1.2 billion were traded off the LSE. With current systems there is absolutely no way that any exchange can properly handle the surveillance of total market activity to detect abuses when the bulk of trading in that stock takes place elsewhere. And regulators concentrate on monitoring reported trades, not the full detail of the development of the orderbooks that preceded the trades. Furthermore, with electronic trading, the potential for abuse has also increased. For instance the FSA's Market Watch recently raised the issue of layering or spoofing the orderbook, stating that, 'exchanges and MTFs will have procedures in place to prevent this activity', but if you're only seeing a third of the activity, or not looking at all the orderbooks, how can you properly deal with these problem areas and ensure investor protection?"

"Given this apparent lack of protection we would expect buy-side players and investors to be demanding reassurance that their trades have been executed at fair prices, just as they now ask whether they achieved best execution. Even if best execution is achieved it may be at

unfair prices as a result of market abuse.” Abuses such as front running client orders are suspected to be rife, but are now even more difficult to detect. The potential losses to investors are very substantial. MAD demonstrates the will to tackle this problem, but at present the means are inadequate.

According to Avenues, surveillance is the least effective of the five market functions of listing, execution, clearing, settlement and surveillance. Leegood added, “A huge effort has been expended by exchanges, clearers, settlement agencies and regulators on the first four of these five functions. But surveillance activities, which are at the heart of well run, transparent markets, have not been properly addressed since MiFID leapfrogged MAD”. Avenues has concrete proposals to address this problem, and intends to investigate further in detail in the coming months with input from all parties, including the buy side, sell side, liquidity providers and regulators and exchanges. “There is a potential scandal in the making here, and we want to work with the industry to prevent it becoming an actual one.” says Leegood.

Notes to editors:

Avenues is the Alliance of Independent Advisors to Financial Markets formed by four respected advisors in exchanges, trading, post trade and technology. These are:

Bryok
BTA Consulting
Capstan Consulting
Golden Advisors

The AVENUES Alliance provides independent world class expertise and thought-leadership to advise and assist clients in financial markets. Together the alliance has served well over 100 clients in the financial services sector around the world and enjoys a superb track record of success. For trading venues we have taken on executive and line management roles and led the development of advanced technology. We are well used to helping our clients assess their strategic direction, and our experience of high level IT and operational management contributes to practical implementation of strategic plans.

AVENUES consultants have specific experience in establishing and supporting supervision and surveillance functions and in leading thinking about the future of these functions. We are abreast of the latest and emerging developments in products and IT components relevant to surveillance systems and their relationship to other key trading systems.

In addition to advising a number of surveillance technology providers, AVENUES people have worked extensively on surveillance with exchanges such as SIX Swiss Exchange, PLUS Markets, Oslo Børs, Doha Securities Market, and the Bahamas International Securities Exchange, and with regulators such as the Financial Services Authority and Qatar Financial Markets Authority.

For further details please contact Simon Bates on 079 7345 2583, or simon.bates@bryok.com