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Market abusers have nothing to fear in Europe

The fragmentation caused by the Markets in Financial Instruments Directive has left the European equities market wide open to abuse and virtually no-one is able to prevent it, according to Avenues, an alliance of independent consultants to the financial markets. It says that regulators should enforce a single standard of data elements across trading venues in Europe to create transparency in trading.

"The fundamental difference between Market Abuse Directive and MiFID is that MAD was national and MiFID was pan-European. It is impossible for regulators to see pan-European activity - they don't have the right. A regulator in Luxembourg cannot see trading undertaken in their stocks in London and vice versa," said Brian Taylor, managing director of BTA Consulting. "It has introduced such levels of competition and fragmentation that we've got away from the point we were at of having a fair and orderly market. It would be very difficult for anyone to say that there is a fair and orderly market today. The key principle that MiFID introduced, that of best execution, is simply not happening."

Avenues have produced circumstantial evidence that illegal activity already occurs. Steve Leegood, of consultancy Bryok, noted that according to the FSA's own market cleanliness statistics, "At least a third of the time insider trading is happening," e.g. the market has moved before an announcement. "Front running is said to be rife. It is fairly easy to spot if you are working on one trading venue, but as soon as you have multiple venues where this can take place, you can't spot front running. At a stroke fragmentation makes spotting front running much harder." Surveillance doesn't appear to be working - despite the FSA's figure of 30-35% insider trading, it has carried out just 280 investigations over the last 10 years.

Taylor noted that the granular level of data, that identified the trader and the beneficial owner of a security is no longer demanded. Where the trader and owner cannot be identified, if market abuse is suspected the data needed to take the case to court is flawed. "A defence lawyer can easily challenge who the actual trader was as there is no audit trail. MAD has never specified this and with increased competition, venues are driven to reduce the granularity of data so they don't lose liquidity - they are conflicted. They need less granularity to allow more firms to use them," says Taylor.

As an example of the limited nature of surveillance, 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% of the total trades, with some 18% being done on MTFs and almost 50% in dark pools, OTC, or on systematic internalisers.

Leegood 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 order book, 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?"

He continued "If a trade is carried out on an internal crossing network, a systematic internaliser or on a dark pool then there is no pre-trade transparency. The trades are reported on Boat. Market Boat's regulated status is as a trade data monitor. TDMs have no market abuse monitoring obligations. So you have 20 - 30% of the market with no market abuse monitoring going on. So it's a totally unlevel playing field between different venue types."

To resolve the issue, Taylor believes that "Regulators need to align themselves with the pan-European market. In addition, they need to define a single standard set of data elements, captured by all venues, such that the investor is actually protected. If it was applied on a pan-European basis it would actually improve the quality of the market," while MAD itself need to be re-reviewed.

The only problem is that almost no-one has any motivation to make this happen. The people losing money ultimately are the investors says Avenues, but of those, the only ones that have the clout to push for change and are financially motivated to do so will be Sovereign Wealth Funds or perhaps governments "Ultimately it will be a macro-economic issue, as investors lose confidence and say they are not going to invest in the markets" notes Leegood.

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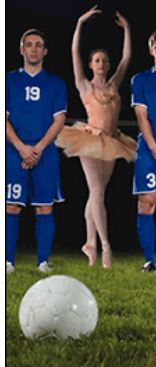


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