

STRAP: Exchanges

HEAD: Unintended consequences

INTRO: MiFID has legalised cross-border trading while leaving market surveillance national, which is causing pension funds and SWFs significant losses

Much play has been made in the media recently about the UK financial regulator 'getting tough' with financial sector crime in the City. The Financial Services Authority's dawn raids and subsequent arrests of seven bankers on various charges of front-running, insider trading and other forms of market abuse have played well in the papers, which are not averse to 'banker-bashing'. With its future in question, the FSA has been desperate to prove it is up to the task of ensuring fair play in the financial markets. In a press release, the FSA proudly said its 'Saturn' investigation involved 35 investigators, lawyers and officials poring over 200,000 electronic files, 130 trading accounts, 75 electronic devices and taking more than 250 witness statements.

If only it were so simple. The FSA is an agency of the European Commission, which has ultimate authority over the financial sector in the European Union. The irony is that, as a result of the Commission's MiFID regulations, designed to free up Europe's financial markets from the dominance of national exchanges, the potential for market abuse has increased substantially. Avenues, the Alliance of Independent Advisors to Financial Markets (which comprises specialist consultants Bryok, BTA Consulting, Capstan Consulting and Golden Advisors), says the function of ensuring markets are fair – the surveillance of bids, offers and trades – is now "almost impossible to undertake comprehensively, given the fragmentation of trading on competing exchanges and trading platforms such as multi-lateral trading facilities, dark pools, systematic internalisers and OTC trading".

The current regulatory framework is fundamentally flawed. The Markets Abuse Directive, issued in 2005, prohibited insider trading and six other forms of market manipulation across the EU. Two years later, MiFID introduced passporting of almost 8,000 stocks across the EU, but without the necessary cross-border supervisory powers. "Regulators have no cross-border powers to see how stocks are traded in different jurisdictions. We have lost fair and orderly trading," says Brian Taylor, managing director, BTA Consulting.

Steve Leegood, founding director of Bryok Systems, says: "Now, no single body can monitor the trades of a stock. The London Stock Exchange only sees 65% of Vodafone stock, even though the stock is listed on the exchange." 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.

Nor does MiFID ensure that standards are maintained. Taylor says: "There is no independent standard to maintain the law. If an MTF wants to cut costs to meet competition, they can cut monitoring without fear of sanctions. They are conflicted." MTFs do not invest in comparable surveillance infrastructures and internal broker-dealer crossing networks are in effect unregulated in MAD terms. Effectively, MiFID has legalised cross-border trading while leaving market surveillance national.

Leegood says: “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 order books 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 order books, how can you properly deal with these problem areas and ensure investor protection?”

The real risk is that buy-side players and investors are not getting their trades executed at fair prices. “Even if best execution is achieved, it may be at unfair prices as a result of market abuse,” says Leegood. “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.”

The large national pension funds and the sovereign wealth funds, as the largest traders of stocks on the exchanges, are reckoned to be the biggest losers from a system that is wide open to abuse. All the reforms to the stock trading infrastructure over the past few years have benefited the sell-side, the same investment banks that have set up MTFs with the express purpose of breaking the monopolies formerly held by the national exchanges.

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QUOTES

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