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Fragmentation invites market abuse, experts claim

The dispersal of equities trading across multiple venues in post-MiFID Europe has increased the opportunity for unscrupulous traders to abuse the system and made policing of some illegal practices next to impossible, according to a newly-formed advisory and lobby group.

Avenues, a consortium of four consultancy firms focused on exchanges, trading, post-trade and technology, contends that the European Commission's Market Abuse Directive (MAD), introduced in 2005, was not designed to cope with the pan-European, multi-venue trading environment ushered in by MiFID two years later. While MAD is a pan-European directive, it only envisioned trading within member states' national borders.

"When you are looking at surveillance, it is impossible for national regulators to see pan-European activity," said Brian Taylor, managing director of BTA Consulting, one of the four Avenues members. "Even though MiFID introduced an excellent set of competitive standards, it has probably taken innovation too far. It has introduced such a level of competition and fragmentation that we have got away from the original point, which is a fair and orderly market."

He added, "It would be very difficult for anyone to say that there is a fair and orderly market today."

In addition to BTA Consulting, Avenues, which was specifically set up to examine the problem of market abuse, comprises fellow consulting firms Bryok, Capstan Consulting and Golden Advisors. Exchange clients of the group's members include SIX Swiss Exchange, PLUS Markets, Oslo Børs, Doha Securities Market and the Bahamas International Securities Exchange.

While Avenues contends insider dealing, one of the seven market abuse types outlined in MAD, is relatively easy to identify, fragmentation has confounded regulators' abilities to detect others, such as front-running. "Front-running is easy to spot if you are just looking at one trading venue because you can see all of the activity," said Steve Leegood, founder and director of Bryok. "As soon as you have multiple venues, you can't spot that pattern of activity. Fragmentation makes spotting front-running much harder."

Certain aspects of MiFID have also made trades easier to hide from regulators. For example, under MiFID, over-the-counter equities trades can be reported to trade data monitors such as Markit BOAT. However, unlike the national exchanges that performed the reporting function before MiFID, trade data monitors have no market abuse monitoring obligations. Trades reported to Markit BOAT alone accounted for 21.73% of pan-European equities turnover in February 2010, according to data vendor Thomson Reuters.

"A huge volume of business has no market abuse monitoring, which creates a totally uneven playing field between different venue types," said Taylor. "There is a perfect opportunity to be totally invisible from a surveillance point of view."

To illustrate the potential size of the problem, Avenues estimates that if the value of a market abuse opportunity is one basis point, which Taylor argued is a very conservative estimate, this equates to €100 million a year based on the federation of European Securities Exchanges' February 2010 turnover statistics, and could be anywhere between €100 million and €1 billion if it is assumed that the opportunity is worth more than 1 bp.

Avenues' next step over the coming months will be to determine what can be done about the post-MiFID market abuse problem. Taylor is meeting Maria Velentza, head of the securities market unit at the European Commission's internal market and services division, on Friday. The organisation is also canvassing the opinions of exchanges, regulators, legislators, buy- and sell-side participants, issuers and third-party suppliers.

"There is an awful lot of inertia, some complacency and even maybe a bit of complicity around this so the industry on its own may not change," said Leegood. "We are also doing some lobbying of people who can instigate and enforce change."

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