Editorial

Fragmentation poses challenges for market surveillance

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In 2007, the Markets in Financial Instruments Directive (MiFID) was introduced to open up the European exchange industry to competition while increasing trading transparency. Three years later we can observe that while the competition element of MiFID was successfully implemented, the objective of increased transparency has failed on several accounts. A substantial portion of European trading still takes place outside of MiFID-regulated venues, while the increased fragmentation has presented significant challenges for surveillance professionals. There is currently no system for surveillance of order-level information across different venues, which makes it very difficult to discover market abuse. Hence, while MiFID opened up markets for competition, it did not properly address how surveillance should be conducted in a fragmented world.

Before MiFID came into effect, national exchanges had a comprehensive and complete picture of order books and transaction flows. However, the increasing portion of market share traded on MTFs has fractured this picture. Today, the same security may be traded on multiple venues, but each venue only has responsibility for surveillance of its own marketplace. As a result, no one has overall responsibility for surveillance in a given share, and no one has a complete view of the transactions across all venues.

This environment has made it easier for certain types of market manipulation to go undetected. There is, for example, currently no system for monitoring order information across venues which would reveal manipulative practices, such as "layering", where traders send multiple orders priced closely to the current best bid and offer to create the false impression of liquidity in a stock.

Other market abuse tactics include so-called "front running", where brokers can trade ahead of a client's order and benefit from the price movement caused by this order. Moreover, dark pools can be manipulated by placing orders onto the lit books that narrow or move the best bid and offer reference. These schemes involve two different venues and take advantage of the fact that it is impossible within the current surveillance structure to see the connection at the exchange level.

Furthermore, operational issues constitute a challenge to solve the multi-market surveillance dilemma. Market operators often respond to high volatility in a single security by calling a trading halt in that stock and issuing a price query to the listed company. This enables market participants to take in newly disclosed information and allows price discovery to occur through a call auction. Sometimes, however, alternative markets disregard the halt and continue trading, allowing participants with unfair access to information to trade before the primary market re-opens. Consequently, local regulators can today receive reports of transactions in a security during a trading halt that took place on venues that do not list the security.

Needless to say that the surveillance fragmentation issue is one that needs to be engaged. The whole market will benefit from a European regulatory framework that calls for collaboration between regulated exchanges and other venues that trade their shares, as well as the exchange of confidential information.

The next edition of European exchange legislation, MiFID II, is evaluating regulatory measures in line with this to strengthen market surveillance on a European level. Consultation papers on MiFID II suggest that operators of regulated markets and MTFs that trade the same financial instruments should be required to cooperate and exchange information to better detect market abuse or misconduct across different markets. Venues would have to inform each other and the regulators when certain conditions arise. Such information exchange would include a decision to suspend or remove a financial instrument from trading, a system disruption such as the triggering of a circuit breaker, and disorderly trading conditions or conduct that may involve market abuse.

For that vision to become a reality, surveillance departments at exchanges and other trading venues need to develop the infrastructure and processes to efficiently share sensitive information in a secure manner. Given the complexity of this operation, it will make sense for some trading venues to outsource it to an entity that has the expertise and advanced technology to handle it. NASDAQ OMX Nordic believes that the ideal route would be to allow the home market of each instrument to take primary responsibility for trading surveillance of that instrument, while enforcing trading information to be shared between regulated and alternative marketplaces. Only when this surveillance framework is in place can we efficiently and proactively prevent market abuse and manipulation in order to create a transparent and fair European securities market.