

The original Market Abuse Directive (MAD) came into force in 2005, pre-dating MiFID 1 by a couple of years. Since 2005 there have been huge changes to the way markets operate. In equity markets alone we've seen lit market fragmentation, HFT gaming, the rise of MTF and Broker operated Dark Pools and an order of magnitude increase in the speed, volume and complexity of trading.

The core principles for detecting Market Abuse remain the same now as in 2005:

- identify those profiting from access to information they should not use, i.e. insider dealing, client front running, trading ahead of embargoed news events
- identify those attempting to manipulate market prices or data to mislead other participants and create profitable trading opportunities (layering, spoofing, reference price manipulation)

However, although the basic principles remain the same, the ways in which a potential market abuser might operate have multiplied markedly since 2005 due to increased market complexity.

## Detecting market abuse is about to get harder

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Consider the example shown in Figure 1 opposite, taken from public market data (identities of participants unknown to us).

■ Figure A shows a multi-venue order book with all orders on European lit venues for a UK stock.

■ The best European offer price of 621 at this instant is based on 300 shares resting on the LSE (blue background). The order book is interesting in that other than those 300 shares there are no other competitive offer prices on the LSE.

■ A millisecond later, the 300 shares on the LSE are cancelled (not traded).

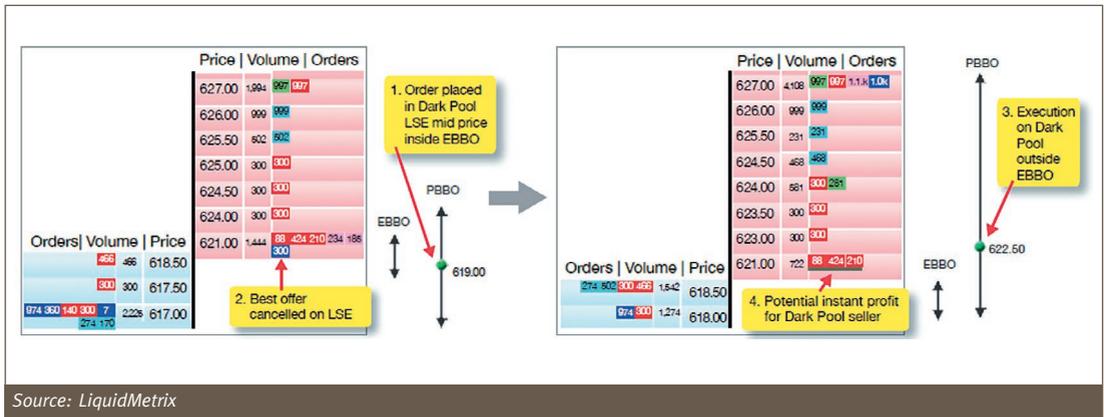
■ A few milliseconds after the cancellation a trade for exactly 300 shares was registered on a Dark Pool at the (then badly skewed) LSE mid-price of 622.5. This was clearly a very bad price for the buyer on the dark pool as it was significantly above the offer prices available on MTF lit venues. It would be safe to assume the aggressor in this trade was the seller.

That's the story from the public tapes, Now let's think what might have actually happened.

■ Maybe the owner of the 300 shares on LSE cancelled the 300 resting shares and someone else chose that instant to aggress the Dark Pool obtaining the favourable selling price. In this case the aggressive trade to the Dark pool was possibly opportunistic, but it would be hard to classify this as market abuse by that participant, they simply took advantage of a visible price anomaly.

■ Maybe the owner of the 300 shares decided to cancel their order and send an IOC sell order to a set of Dark pools in the hope of finding liquidity there rather than waiting for a fill on the LSE. If this was an algorithm that would have re-posted the 300 shares onto the LSE again if no Dark Pool match was found, then it would be harsh to characterise this as abusive behaviour.

■ Maybe the owner of the 300 shares identified the



Source: LiquidMetrix

opportunity that by cancelling their own order they would badly skew the LSE mid-price such that they would obtain an instantly profitable position if they managed to hit a Dark Pool (they could immediately buy back any shares they sold on the Dark Pool on a number of MTFs with lower offer prices).

The point of this example is to illustrate how increased complexity both creates new opportunities for people wanting to profit by manipulating market prices and also at the same time makes detection of such activity more challenging.

Recognising the changes to how markets operate nowadays, the new Market Abuse Regulation (MAR) agreed in 2014 and due to come into force 3rd July 2016 will significantly expand

the remit of what types of market abuse firms will need to monitor and be held accountable for. In terms of our example above, the new provisions specifically identify the need to monitor transactions on multiple trading venues including MTFs.

They also emphasise analysing not just trades but also actions such as modifying or cancelling orders where this might indicate insider knowledge or is an attempt to manipulate market prices. Our example began not with a trade but with an order cancellation.

The other major extension is that trading in several non-equity products will also come into focus and cross asset manipulations (manipulate spot to affect derivative etc.) must also be detected.

Upgrading systems to meet the challenge of

looking for these new high frequency, multi market, multi asset type abuse cases will be challenging as it will require a much deeper analysis of market activities surrounding trades than was previously required. On the plus side though, many firms will have already invested in upgrading algorithms/TCA systems to meet the challenges posed by fragmentation and high frequency trading, so significant synergies with this work should be possible.

After all one person's Best Execution failure might well be as a result of another person's Market Abuse. The systems for detecting both are similar in technique if not emphasis. ■

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