Topic 2: Investor Protection and Market Integrity

Introductory presentation – Michael Evans and Wu Xiaoling
Interactive discussion: Question 5 – Howard Wetston

Question 5

With the evolution of trading and technology, including the increased use of algorithmic and high frequency trading, there are new challenges for market surveillance. For example, the volume of order traffic has increased substantially and new forms or variations of market abuse may have developed. Do you think the existing market surveillance tools and processes are capable of coping with the changes? What new or additional surveillance tools and processes would regulators need?

(3-4 minutes)

SPEAKING NOTES

Market surveillance

The performance of market surveillance has become increasing complex. Regulators not only have to deal with high frequency trading and algorithms, but multiple markets trading the same securities and cross-asset trading.

The world is also getting smaller as more and more products are being traded across borders and as a result, market surveillance is complicated.

In the context of its report on the impact of technological changes on market integrity and efficiency, IOSCO has recommended that market authorities monitor markets for new forms of abuse and make sure that their systems and rules keep up.

This means that regulators need to constantly update their regulatory requirements to ensure that their requirements are clear and capture new behaviour that could constitute abuse. For example, regulators should clarify rules or guidance related to market abuse, consider requirements related to “fair and orderly trading”, or more responsibility placed on those that trade using algorithms.

Where they use automated systems to monitor trading, there needs to be a constant review of alerts, parameters and reports. The systems need to be robust, scalable and able to adjust quickly to changing markets.

As markets and trading change, regulators need to stay on top of these changes and ensure that they have the right tools to manage them. The way they do so may differ.

In my view, at minimum, regulators, whether SROs, exchanges or statutory regulators, must have electronic monitoring of trading on a particular market – and in most jurisdictions, this is being done at the exchange level.

The question is whether single-market monitoring is enough.

Regulators, depending on the sophistication of the market, and again its structure and regulatory requirements, need to determine if it is necessary to monitor all trading that occurs across multiple marketplaces – either multiple marketplaces within a particular jurisdiction or across borders.

It is my view that the best and most effective way to monitor in today's environment is to monitor trading in real-time across multiple marketplaces. This is our approach in Canada.

Some background – in Canada, we introduced a framework for competition in trading in 2001. Today, we have 12 equity marketplaces operating and trading the same securities. In May 2010, IIROC, the Canadian SRO that oversees trading on all equity marketplaces, introduced its surveillance system STEP.

The system brings together orders and trades in real-time from all 12 marketplaces and creates a consolidated book. This system enables IIROC to monitor trading across all equity markets and run alerts and post-trade reports on a consolidated order book. Australia and a few other regulators are using a similar system.

We do not currently monitor across multiple asset classes – for example, trading in equity options and their underlying securities.

However, we have requirements relating to cooperation between those that monitor derivatives and equity trading. As required by the IOSCO standards, we need to continually evaluate this type of arrangement to make sure that the coordination and communication between regulators is sufficient and, if not, to determine whether systems need to be built that can monitor and identify abusive patterns in both markets.

There is concern that the growth of unregulated OTC derivatives markets may provide market participants increased opportunities for market misconduct. Specifically, market participants may attempt to manipulate the prices of securities or derivatives in one market to affect the price of the underlying assets in other markets or the value of a derivatives position.

In order to identify manipulative schemes involving multiple markets and various participants, it is necessary to have a view of the various markets and to understand the inter-connectivity between markets. An important priority is the development of a comprehensive surveillance system which supplements current market surveillance with OTC derivatives surveillance, and includes cross-product and cross-market analysis.

The cross-border issue is an interesting and complicated one – and I think that over the last number of years, regulators have been entering into bilateral compliance and enforcement MOUs that would enable them to share information about potential market abuses.

I know that in Canada, we are drawing more and more on these arrangements to coordinate and talk to other regulators regarding potential issues that may arise.

It is important to emphasize that “one size does not fit all” – the response by a regulator to challenges associated with market surveillance differs depending on the market, its structure and its regulatory framework.

The key is for regulators to continue to monitor and be aware of the changes, to adapt quickly and to have resources and tools to ensure market quality and integrity.