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COURSE
11456B

Market Abuse Regulations from a Trader's Perspective

Regulations around market abuse look very different depending on where you're standing. This course takes a trader's-eye view of market abuse rules, exploring how these regulations are experienced, interpreted, and sometimes circumvented on trading floors. For CPAs and financial professionals who advise trading firms, broker-dealers, or financial services clients, understanding this perspective bridges the gap between regulatory intent and real-world behavior. You'll come away better equipped to identify compliance gaps and counsel clients on the practical implications of market abuse frameworks.

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Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 5 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

Course Objectives

- Identify the characteristics of, and potential reasons for, wash trades.

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Chapter 1: A TRADER'S PERSPECTIVE ON MARKET ABUSE REGULATIONS

Chapter Objective

After completing this chapter, you should be able to:

- Identify the characteristics of, and potential reasons for, wash trades.

10.1 INTRODUCTION

This is a personal account of a trading journey which started in 2005 when I developed a passion to understand the information that drives financial market prices in a certain direction, and execute trades accordingly. I examine market abuse regulations from my perspective as a trader, describing them to those not so familiar with the markets with as much detail as possible. I explain, using plenty of practical examples, how these market abuses might be used to gain an edge and profit the executor of the trade, and how these abuses of the market would affect the trading process of a trader witnessing the market abuse. I explore two case studies in detail. Both try to find an edge in the market by using clever order management and executing techniques, one of which is currently deemed legal and another which has resulted in a conviction and fine. I describe how major exchanges are complying with the new market regulations to stop abuse, and how they are working with market participants to make sure that the rules are understood and adhered to. I will share what my company is doing to comply at business entity level and at trader level and conclude with discussions on limitation on regulations from governing bodies and rules set by exchanges.

The focus of this chapter is the European Market Abuse Regulation (MAR) which is a directive covering all European exchanges which came into force in July 2016. This standard was introduced to modify the existing legislation governing market abuse and brought with it a broader scope of regulation and focus on identifying and eliminating abusive behavior in all sectors of the financial markets, creating a legal obligation to have trade surveillance and submit reports on an exchange, trading firm and individual trader level. In the UK this is overseen by the Financial Conduct Authority (FCA) and in Europe by the European Securities and Markets Authority (ESMA).

During the last few years Europe has implemented some of its most far-reaching financial services regulations. There has been a period of unprecedented regulatory change, increased oversight and tighter scrutiny. Increased regulatory focus since the financial crisis of 2008 has led to a more concentrated global regularity force. Swathes of regulation have been introduced to govern previously untouched areas of the financial markets and to increase scrutiny on those areas seen to pose the most risk to financial stability.[1]

As a trader operating pre-2008 there were very few documented cases of market abuse and very few investigations taking place. We were, after all, living in a globalized free marketplace where markets moved, sometimes orderly, sometimes irrationally, but you placed a trade, took a chance and there were winners and losers. After the financial crisis in 2008, governments around the world realized that the way the financial world was operated, and to a lesser extent self-regulated, had to change.[2]

My first proprietary trading house role was working with seasoned London International Financial Futures and Options Exchange (LIFFE) floor traders who specialized in short-term interest rate futures. Specifically, the firm focused on EURIBOR (European interbank offered rate) futures and short sterling futures (UK interest rate market strongly linked to LIBOR, the London interbank offered rate) benchmarks of where the markets believe interest rates will be priced in Europe and the UK, respectively, at certain points in the future. Financial institutions, banks pension funds, insurance companies, investment houses and governments would look at the market perception of where rates would be and react to those prices accordingly to hedge any exposures they might have to interest rates moving either up or down. There are a large number of events that can move the price of an interest rate futures contract within the UK or the eurozone, far too many to list here. At the start of my path as a trader, however, I was armed with just the basics of fundamental analysis, i.e., macro-economic news, macro-economic data, central banker's opinion, political shocks, and the regular release of the LIBOR fixings.

LIBOR was announced every Thursday at 10 a.m. It was an average of the interest rates estimated by each of the leading banks in London that it would be charged if the bank were to borrow from the other banks. It is the primary benchmark, along with EURIBOR, for short-term interest rates around the world, and how it was set in the present would have a knock-on effect on the rate in the future. A very big deal was made of the LIBOR announcement because, as per the efficient market hypothesis, the price of every asset reflects all known information about it at any one time. So putting theory into practice we would all be waiting with bated breath for the weekly LIBOR figure to be announced so we could use it to reprice the short sterling yield curve accordingly. Higher than anticipated LIBOR would indicate rate increases in the future and give us as traders the signal to sell the short sterling contract. A lower than anticipated LIBOR would indicate possible rate decreases in the future and therefore we would be seeking to buy short sterling futures. We would get the information in audio format from what is known in the industry as a "squawk," a desk of researchers whose job it is to keep their eagle eyes scanned overall the newswires – Bloomberg, Reuters, Market News International, Dow Jones news, and all the commercial news stations, to then squawk the news over a PA system as quickly as it is read, so that traders can react to the data or news as quickly as possible. By using a squawk, traders could be fully focused on the markets, not having to read the data to then jump back to reading the market and possibly missing the market move.

So, there I am – a young trader ready to make his mark in the world of financial futures. The big release of the day is imminent, my palms are sweaty, and I am nervous with anticipation – realizing

that making the right decision will make me a great deal of profit if I'm quick enough to disseminate the data and trade with speed and accuracy. The clock strikes 10 a.m., the squawk is as quick as it can be, and I react to place a trade on the short sterling market which is directly related to the pricing of LIBOR. But . . . nothing happens. It's as if the market knows the information already – 10 a.m. on Thursday is when I get the LIBOR rate fixings for that week – but someone else obviously gets them before me.

This was way back in 2005/2006 and since then, as mentioned earlier in this course, it has come to light that LIBOR at that time was rigged. My gut feeling and the feeling of the majority of market participants at the time was right – someone was getting the data early and the market was moving prior to its release. On 27 July 2012, the *Financial Times* published an article by a former trader which stated that LIBOR manipulation had been commonplace since at least 1991.[3]

Banks were falsely inflating or deflating their rates to profit from trades or to give the impression that they were more creditworthy than they were. There have been multiple agencies around the world that have sought to bring justice against those involved in the LIBOR fixings over the years, most of which are already well documented in this course. What stands out for me is the release of a transcript of a conversation that happened on 19 August 2007 between Royal Bank Of Scotland trader Tan Chi Minh and Deutsche Bank's Mark Wong:

> Tan: *." . . it's just amazing how LIBOR fixing can make you that much money or lose it. It's a cartel now in London."*
>
> Wong: *." . . must be damn difficult to trade man, especially if you are not in the loop."*[4]

Well, Mr Wong was right, it is extremely difficult to trade when the playing field isn't level and the market is being abused by traders' at large institutions that are rigging the data to their benefit week in, week out, and trading on that information days before the rest of the world sees it.

10.2 GETTING THE TRADING EDGE

Since my time starting out as a short-term interest rate trader I have since developed into a multi-asset multi-exchange macro trader, trading a very diverse portfolio of financial futures, commodity futures, agricultural futures and energy futures. Alongside my own personal trading I have been recruiting, teaching, mentoring, and managing university graduates who want to follow a similar path into futures trading on the world's leading exchanges: CME, ICE, EUREX. My time as a trader and trainer has placed me well to understand why markets do get abused.

Trading is all about the edge. How do we define what the "edge" is as a trader? For some it could be detailed technical analysis, the ability to read a chart, study where the price has been, or how it's got to the current point and where it will be going in the short, medium, or long term. For others, it could be the ability to disseminate fundamental information about an asset class, reading between the lines in a forensic manner, trying to find a piece of the puzzle that unlocks the holy grail of price

discovery. Or, rather than constant in-depth analysis of the information, a trader could merely have the fastest trigger finger when it comes to reacting to information that is released. A trader could simply watch the order flow through the market and try and gain an edge from spotting simple patterns between prices using the order book, order flow, or the size as a reason to trade.

Now, having traded for many years, and having trained over a hundred traders, I can tell you that all the above ways to gain an edge in the futures market are very hard indeed. There are thousands of participants all over the world looking at all the very same information you are, the same technical analysis chart, reading the same fundamental information, reacting at the same time when data is released, and looking at the same price action as you are. The competition is tough, but the rewards are not only financially uncapped; as a trader you get the instant feedback of knowing all your hard work in preparing and executing your trade was essentially right.

The high-profile cases of the LIBOR and EURIBOR traders show a clear case of greed as a motivation. Christian Bittar, recently jailed for over five years and four months for his part in trying to rig EURIBOR, was once one of Deutsche Bank's most profitable traders. At one point he earned £47 million in commission in a single year, on top of his £130,000 basic salary. Judge Gledhill said, "Greed alone does not provide an answer to Bittar's actions and that he had been motivated at least in part by the satisfaction of being able to beat the system undetected."[5] This beating of the system, undetected as described by Judge Gledhill, is the ultimate edge and will be the focus of much of this chapter.

There was an another incident of a junior trader in the company I worked for trying to gain an edge by attempting to game the matching algorithm of one of the exchanges that we traded on at the time. A matching algorithm is used by a trading exchange, ICE, CME, etc., to determine which market participant gets allocated a fill of their order of contracts when a bid or an offer is traded at the best market price. There are two order allocation matching algorithms used by exchanges: first-in first-out (FIFO), and pro- rata.

It is best to explain the pro-rata order allocation with an example. In this instance the market is bid at 5.5 for 100 contracts, this bid is made of five participants each wanting to buy 20 lots at that price:

$$20 + 20 + 20 + 20 + 20 = 100$$

A limit sell order at the price of 5.5 for 60 lots is entered and gets matched with the bid working at 5.5; it is the matching algorithm's job to determine who gets their orders completed on that bid and for how many contracts.

In this instance there are 5 participants each with 20 contracts working on the bid, and only 60 contracts have been sold. So, who gets allocated the 60 contracts that have traded out of the 100 contracts that are on the bid?

This is where the matching algorithm comes in. It's the algorithm's function to determine that there is an even allocation of contracts over those 5 market participants' working orders on the bid, in this instance the algorithm would allocate each of the 5 participants 60% of their order working on the bid, i.e., 15 contracts. The percentage allocation can be adjusted by the exchange at any time, but this example is based on the current calculation used by the CME.

All large exchanges use either a matching algorithm to allocate order distribution or a FIFO Q-based order allocation system. In the example we used previously, the 60 contracts that were sold at 5.5 would be split to the first 3 orders of 20 lots to be places on the bid, first in the market and then first out when the price trades.

The trader in question had worked out that they could split their order working on the bid or the offer on an exchange using the pro-rata matching algorithm into multiple orders to gain advantage over the matching algorithm. This would increase their share of any contracts trading where they had an order.

For instance, if the market was 5.5 bid and there was still 100 on the bid, made of 4 orders of 20 contracts, but the final 20 being made of 20 orders of 1 contract but by the same participant, the order was split from 1 order seen by the exchange to 20 individual orders:

$$20 + 20 + 20 + 20 + 20(1 + 1 + 1 + 1 + 1 + 1 + 1 + 1 + 1 + 1 + 1 + 1 + 1 + 1 + 1 + 1 + 1 + 1 + 1 + 1) = 100$$

Then when the order to sell 60 lots is entered and gets matched with the bid at 5.5, the matching algorithm would naturally have to give out a fill to all those orders for 1 contract because 60% of 1 contract would have to be a 1 contract; the algorithm cannot deliver an order smaller than 1. So instead of getting a fair distribution as intended to be delivered by the exchange, the trader in question managed to get a complete fill of 20 contracts rather than their fair share, which would have been 15 had they placed 1 order for 20 contracts. This would leave the other participants' working orders on the bid at 5.5 with a reduced order allocation. It was a very simple and accessible way to gain an edge for the trader over other market participants; receiving more than their fair share of contract allocation would lead to greater profit potential but had consequences.

In the above example, the trader in question was contacted by the exchange for persistent order splitting and given a warning: should this practice continue he would be banned from trading on the exchange and fined. This was an easy piece of self-regulation on the exchange's part, as order splitting is very clear, defined, measured, and simple to stop.

My close encounter with a market abuser was caught early on and the lesson was learned company wide. Order splitting hasn't been defined in the new Market Abuse Regulation (MAR) laid out for the financial markets. The rules set by the exchanges are clear, orders should be placed for the correct number of contracts only at any price with no exceptions. There was an obvious advantage to order split that enticed the trader, but no way another market participant could tell that the offence was

taking place. Luckily the exchange policed the market and the offender was stopped. The next part or the chapter will look at the market abuse regulations, how they are executed, and how they affect trader's decisions.

10.3 A TYPICAL TRADER'S MARKET WINDOW

In order to successfully explain the number of abuses laid out in MAR I will first of all show an example of a typical trader's market window which gives us the information we need to enter a trade and to understand how abusers operate.

An example of a typical trader's market window is depicted in Figure 10.2. The market window has been broken up into two sections. The sidebar on the left and the live market on the right, which changes in real time as the buy and sell orders enter the market.

FIGURE 10.1 SIDEBAR.

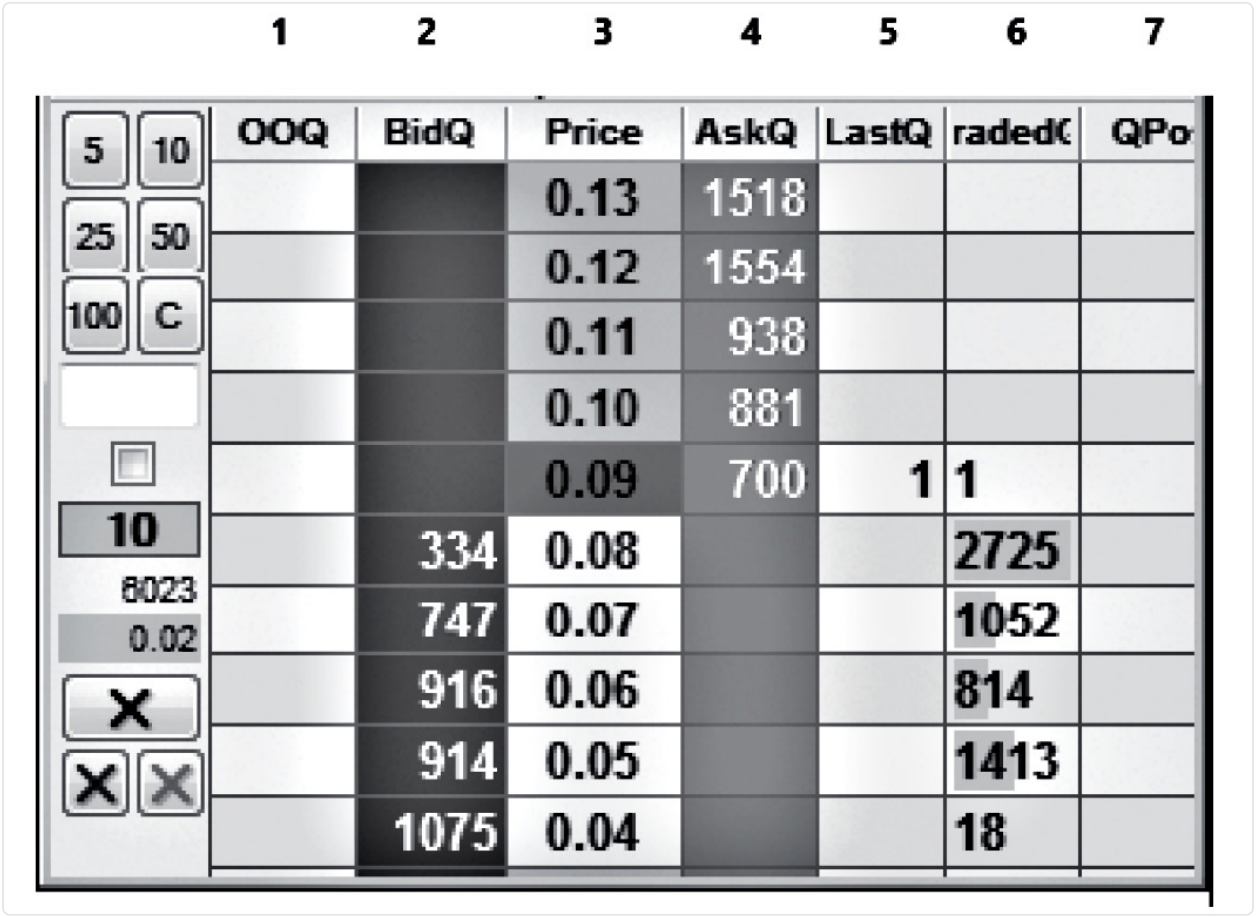


First we describe the sidebar, which is shown in Figure 10.1 above.

1. The numerical pad is used to input the quantity of contracts to be traded.
2. The position window highlights whether the position held is long or short and in what amount. If the trader is long it is highlighted dark gray, and short is gray. In this instance the trader is long 10 contracts.
3. This number below the position window tells us how many contracts have traded in that trading session at that time in that market viewed. At the time of capture the market highlighted had traded 6023 contracts.
4. The gray 0.02 highlights how many prices up or down the market has moved from its settlement price the day before. In this instance it has moved up 2 prices. Dark gray highlights a move up and gray highlights a move down.

5. Dark gray, gray, and light gray X buttons delete certain orders in that market window, all buy orders will be removed by the gray X, all sell orders by the light gray X, and all orders in the market window by the dark gray X.

FIGURE 10.2 A TRADER'S WINDOW OF THE ORDER BOOK.



The live market: the seven columns are broken down as follows:

1. OOQ – Own order quantity. When placing an order, it will highlight how many contracts you are bidding or offering at that price. For instance, should an order to buy 20 contracts at the price of 0.08 be placed it will show the number 20 in Blue (buy) in the OOQ column next to the price 0.08.
2. BidQ – Bid column. This shows all the contracts working on the bids for the entire depth of the market. It is a good measure of liquidity on the buy side and shows the best price at which the contract can be bought immediately.
3. Price – The market price. This shows the best price which can be lifted immediately. At 0.09, have a bid – 0.08 – or offer – 0.09 – worked at market or have a sell order filled straight away – at 0.08.