

Implications of Increased Retail Participation for Surveillance Practitioners

Market operators must monitor trends and influencers, and be on the lookout for new forms of market abuse.

Technological advancements over the years have helped make the financial markets more accessible to both institutional and individual investors alike. It is notable that since the global pandemic began, individuals have increasingly made use of the many access channels available to them, and retail participation in the financial markets has skyrocketed. This trend is having implications for surveillance teams, as well as those responsible for monitoring the market quality and market structure.

Enabling access to the financial markets has been a journey. Thirty years ago, investors had to call their broker to get information about securities and execute transactions. By the late nineties, internet penetration had progressed to the point where self-directed retail investors could trade on brokerage firms' online trading platforms at dramatically reduced costs and commissions. By the early 2000s, mobile phones started to become more prevalent, and brokerage firms began to introduce trading apps, first for institutional clients and later for retail investors as well.

The online trading experience has gotten faster and less expensive since then. Today, new market entrants compete aggressively with traditional brokerage firms for retail investors' business. Both types of providers put significant resources into making their online investment platforms and apps easy to access and more appealing, especially to

younger people. After all, millennials and later generations grew up using computers, mobile phones and tablets, and they expect to be able to do anything on their devices. Vast amounts of research on securities as well as market and economic trends are available at the click of a mouse, or the touch of a screen, and help people to make sound investment decisions. Importantly, ease of access and a positive experience encourages individuals to save for long-term financial goals such as education, retirement and purchasing a home.

"The trend of easy access markets is having implications for surveillance teams, as well as those responsible for monitoring the market quality and market structure."

Three other factors have made the financial markets more accessible.

1. Zero commissions on online trades were introduced, initially by new market entrants, followed by some traditional brokerage firms.
2. Some electronic trading platforms and online brokerage firms now allow investors to buy fractional shares. Investors can purchase stocks based on a dollar amount they select instead of the price of a whole share. Fractional shares are particularly attractive to investors who are working with limited capital but want to build a diversified portfolio.
3. There are several investment forums on social media channels, where people can get trading ideas and learn what others think about the market.

Implications for market surveillance

Investor protection and market integrity go hand in hand. To maintain fair and efficient markets and protect investors, market operators around the world are required to monitor transactions for abusive behavior and other misconduct. Surveillance programs have been designed to quickly detect irregularities and investigate and escalate cases where necessary. Sophisticated systems generate alerts when irregularities occur. Upon receiving an alert, analysts gather as much information as possible to better understand the trading activity and to assess whether a referral for further investigation is warranted.

A thorough investigation of potential market abuse and any subsequent enforcement action can take time and is not necessarily a real-time action. When a determination cannot be made, analysts need to evaluate whether the market structure is working efficiently or the market quality (the ability to execute orders subject to best execution requirements) needs to be enhanced.

Ultimately, manipulation is manipulation, whether the perpetrator is an institutional or retail investor. While manipulative behaviors can occur within both categories, the manner in which they take place could be different. Regardless of the type of investor, surveillance teams will monitor for key behaviors such as spoofing, layering, marking the open or

close, insider trading, wash trading or churning, and pump-and-dump schemes. It is also imperative that retail investors spend the appropriate amount of time educating themselves on ethical marketplace behaviors.

That said, certain challenges have emerged over the last few years. One challenge pertains to monitoring electronic communications, instant messaging and chat on social media platforms. Brokerage firm employees' correspondence is subject to monitoring, and firms have a supervisory obligation to review and retain all email, instant messages and social media posts. However, **individuals who are unaffiliated with financial services firms have no restrictions, and their communications are not supervised. As such, retail investors have no way to validate the authenticity or the accuracy of comments on social media, and unfortunately some may essentially act on a meme.**

A concerning dynamic has emerged since the global pandemic started at the beginning of 2020. Most forms of entertainment are shut down, and people have far more time on their hands. In addition, many people are under financial stress from losing their jobs or being forced to reduce their hours; some are turning to the financial markets as a way to fill the gap in earnings and entertainment. If anything, the chat on social media investment forums has

Key behaviors surveillance teams monitor for:



SPOOFING - when orders are entered without the intention of trading, but instead with the purpose of feeding misleading information about supply and demand. Often these orders are entered and deleted quickly to minimize the possibility of them trading.



INSIDER TRADING - the trading of a public company's stock or other securities by individuals in possession of material nonpublic information about the company.



LAYERING - when traders enter orders at different price depths to give market participants a false impression of the level of supply or demand. Often, they will enter false orders on one side of the book (e.g. buy side), but actually trade on the other side (e.g. sell side).



WASH TRADING OR CHURNING - when a trader excessively buys and sells securities in order to feed misleading information into the market, generate commissions, or game market maker rules.



MARKING THE OPEN OR CLOSE - when traders try to set the opening or closing price. Often, they benefit through their position in a related instrument, for example, increasing the price of a stock to profit on call options.



PUMP AND DUMP - when a trader attempts to increase the price of a stock through buying activity or disseminating misleading information. Normally manipulators have an existing position they would then sell for a profit.

increased, and unwary investors could be influenced to implement risky, short-term strategies that ultimately could result in the loss of hard-earned savings. The regulators are aware of these trends and the increased risk that retail investors could be harmed as a result, and they have published strong warnings in response.

Securities markets are no stranger to market volatility, and sometimes securities may start trading at prices that have no connection to their fundamental value. Dislocations are difficult to maintain for a long period of time because the market structure generally works well. For example, trading halts are intended to promote fair

and orderly trading, and they are typically well organized. Although volatility is not a new challenge, it is still an important one. Retail investors need to be aware that they could get caught in the crosshairs of volatile, disorderly conditions, and potentially lose money as a result.

"Retail investors need to be aware that they could get caught in crosshairs of volatile, disorderly conditions, and potentially lose money as a result."

Regulators conduct cross-market surveillance to detect when disorderly activity, which may or may not be caused by market abuse on one market, has spread to other markets. For example, options prices are directly correlated to the price of the underlying asset, so extreme volatility in a share price has a knock-on effect in the corresponding equities options. In addition, some securities are traded on multiple marketplaces, even in different countries. Although market abuse cases tend to be isolated, and international manipulation schemes are rare, disorderly markets could potentially have a global impact. To this end, the Intermarket Surveillance Group, comprising about 60 marketplaces, was formed so members can share information about activity on their platform that may be tied to activity in another platform.

Best Practices

The financial markets are a source of pride in the U.S. and other countries around the world. Ideally, everyone should have an opportunity to raise capital and participate in the markets. Markets are not just for institutional investors, and clearly the increase in retail investor participation is a positive trend. Many individuals may choose to save over the long term by investing in traditional vehicles such as index funds. Others may prefer to pick stocks and invest based on fundamental analysis and loyalty to certain brands. Either way, retail investors should be encouraged to do fundamental research based on reliable sources, educate themselves about their investments and the associated risks, and determine whether they can afford to take a loss.

Easy access to the markets driven by technological advancements, zero commissions and fractional shares has led to a shift in market participant demographics, and the tangible influence of social media has added complexity. Moreover, market conditions can change quite quickly. **From a surveillance perspective, market operators should keep close tabs on the trends, automate processes, and ensure that their systems and tools are up to date and using the most comprehensive datasets.**

Putting in place the best possible infrastructure and framework sets surveillance teams up for success and ensures that markets are operating with the utmost transparency and integrity, regardless of the market conditions.