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Act now to close the gaps that encourage illicit activity

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US lawmakers and regulators are hard at work trying to unravel last week's precipitous 998-point stock market fall, one that many feared, at least initially, signalled the onset of another severe financial crisis.

Pinpointing the cause is crucial. And on a larger scale, the sometimes dizzying speed of change in the equity trading market, which puts a premium on innovation and competition, has made it imperative that regulators act to close gaps that effectively encourage illicit activity in the shadows.

The lag between market innovation and regulation is particularly pronounced in the increasingly fragmented area of equity trading.

There, we have seen a rapid evolution of how and where trading occurs, and how quickly and transparently it is executed.

High-frequency trading, dark pools and direct access are commonplace, compelling regulators to adapt to ensure that participants play by the rules.

A generation ago, fewer than 10 exchanges handled all US equity trades. Today, orders are routed to some 50 competing platforms.

This complex environment creates opportunities for traders seeking unfair advantage to manipulate markets.

They do so by exploiting inconsistencies or gaps created when the responsibility of regulatory oversight is divided.

Regulatory gaps and splintered oversight make it possible for trading abuses - such as market manipulation, marking the close and front-running customer orders - to be carried out furtively across many markets, with a reduced chance of detection.

Until regulators have a complete view of the equity markets, it will be difficult to effectively monitor, and enforce rules against, this kind of abusive activity.

That is why it is essential to create a consolidated audit trail that provides comprehensive surveillance across platforms and investment products.

We need a single set of eyes to oversee the majority of transactions and to facilitate the necessary progress towards a holistic approach to regulation that addresses the realities of today's marketplace.

Last week's dramatic market spiral was an example of how technology and a fragmented marketplace present serious challenges to regulators.

Regulators must step back and take a serious look at market structure. We need to do this in at least three ways.

First, firms need to ensure that they do not continuously feed in orders once markets have broken with respect to precipitous declines.

Second, firms must properly supervise customers to whom they have given "direct access" to the markets, thereby allowing a customer to trade on an exchange using the firm's market participant identification code.

Any firm that provides its name to and/or sponsors a transaction has a responsibility to ensure the proper reviews for those transactions are in place.

There also needs to be some assurance that the clients making these trades are being overseen and examined regularly by a regulatory entity, especially if they have the ability to affect the market directly and profoundly in a matter of seconds.

Third, we should recognise the fact that when liquidity disappears in today's markets, it disappears absolutely.

When we see cliff moments like we did with the market freefall last week, we need to step back and ask what that means.

I believe it means that we need shock absorbers in the market.

We cannot continually be in the position of going back after the fact to redesign what happened - and what trades should be broken - when markets go close to zero. It is not an acceptable place for regulators, and certainly not for investors.

We saw these warnings in autumn 2008 with its dramatic market volatility. We saw them again last week. It is time to get to work and find the answers.

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