Research points regulators to inside options traders

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Research into how investors are leveraging private information in the options market is set to steer regulators in the right direction to detect illegal trading activity.

A study by Patrick Augustin, Menachem Brenner, Marti Subrahmanyam, and Gunnar Grass called 'How Do Insiders Trade', based on US data firm OptionMetrics data, provides insights into the strategies inside traders in the options market are likely to use, as well as their returns.

The researchers analysed how informed investors trade on news tips based on the timing of announcements and potential impact of the announcement on stock prices in order to identify the strategies inside traders could use to strike a balance between profitability and concealing their informed trades.

They also propose a volume-based measure of informed trading to predict returns and sentiment, which could be used to help firms be more cautious about leaking information, and to help regulators detect abnormal trading activity.

“Market regulators in the US have a daunting task in monitoring inside trading activity, given that there are thousands of stocks and bonds trading and that several thousand stocks have options listed on them,” Augustin said.

“Part of our thought is by having a framework in terms of where to look first we, or regulators/firms, might have an advantage in terms of identifying something.

“It’s like a needle in a haystack. If you have no idea where to start it is hard to find the needle, but if you say it is most likely in that corner it is probably beneficial to start there,” he added.

According to the researchers, inside traders tend to gravitate toward the options markets because options can potentially offer higher returns and their transactions may be easier to hide.

“Stock markets may be easy to monitor compared to the option markets, given the large number of strikes and expiration dates; There are so many different combinations of option strategies that an individual option trade could be just a speculative trade rather than unusual activity.

“In other words, there could be a rational explanation. For example, one could make a case it was a speculative trade,” Augustin explained.

Therefore if firms or regulators have limited resources, it is possible that they will decide not to file a case for illegal activity.

Earlier this year the US Commodity Futures Trading Commission (CFTC) reaffirmed its commitment to monitoring compliance with a particular focus on market and trade surveillance practices, surveillance for disruptive trading, real-time market monitoring practices, and block trade surveillance practices, among others.

Last year the US regulator registered a 69% increase in enforcement actions (https://www.globalinvestorgroup.com/articles/3691314/cftc-enforcement-actions-up-69-in-2018), reflecting its commitment to stamping out non-compliance in the derivatives markets.