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ESMA Issues Final Report on Periodic Auctions

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Trading and Markets RE: ESMA Issues Final Report on Periodic Auctions

The European Securities and Markets Authority (ESMA) recently issued a final report on periodic auctions for equity instruments.[\[1\]](#) The final report follows a call for evidence that ESMA issued last fall to learn more about the increased use of frequent batch auctions following the first suspensions of trading under the double volume cap in the Markets in Financial Instruments Directive (MiFID) II.[\[2\]](#) The final report summarizes the feedback that ESMA received during the comment period for the call for evidence and provides details about ESMA's next steps, which will include issuing guidance on several areas.

Importantly, the final report does not appear to contemplate major changes to frequent batch auctions. ESMA recognizes that frequent batch auctions benefit investors and anticipates that they will remain part of the European equity trading landscape.

MiFID II and Periodic Auctions

As described in the call for evidence, trading venues that operate periodic auction systems collect offers to sell (buy) financial instruments at or above (below) a minimum (maximum) price established by the seller (buyer). The trading system's algorithm uses those offers to determine a single price that maximizes the volume of instruments that can be executed at the price. A specific type of periodic auction—the frequent batch auction—recently has gained market share. Frequent batch auctions have a much shorter duration than other types of periodic auctions (often lasting no more than a few milliseconds) and are typically scheduled on a more ad hoc basis.[\[3\]](#)

Frequent batch auction trading became more pronounced in the European Union beginning in March 2018 when the double volume cap limited the ability of market participants to rely on certain MiFID II pre-trade transparency waivers.[\[4\]](#) ESMA's call for evidence postulated that a number of factors could be driving the increased use of frequent batch auctions, including efforts to circumvent MiFID II's pre-trade transparency obligations and a desire to reduce the impact of speed and latency on trading in central limit order books.[\[5\]](#) According to the final report, respondents expressed differing views on whether market participants

are using frequent batch auctions to avoid pre-trade transparency obligations.^[6] As described in more detail below, however, the report notes that certain features of frequent batch auctions “raise questions as to their compatibility with the transparency requirements under MiFID II,” and identifies several areas that ESMA intends to address through guidance.^[7]

Review of Frequent Batch Auction Characteristics

The final report identifies four characteristics of frequent batch auctions: pre-trade transparency, short auction duration, price determination and self-matching.

- *Pre-trade transparency.* The final report explains that frequent batch auction systems apply MiFID II’s pre-trade transparency requirements in two different ways.^[8]

In the first type of system, an auction is initiated upon the system’s receipt of an order. The system provides pre-trade transparency information only after the submission of a counter order that could result in a possible match. Information on the indicative price and volume is disclosed from that point in time and following any change in the order book. The call for evidence raised concerns that systems that initiate frequent batch auctions upon the receipt of an order provide no information on the trading interest that initiated the auction and, consequently, provide no pre-trade transparency where the auction ends without a possible match. Similarly, if a potential counter order is submitted toward the end of the auction, pre-trade transparency is limited to a very short period.

In the second type of system, an auction is initiated only after a potential match is identified, and the system discloses no pre-trade information prior to the identification of a potential match. Once a potential match is identified, the system initiates an auction and discloses real-time information on the indicative price and volume. Some systems lock in the auction price at the beginning of the auction. The call for evidence questioned whether orders submitted pending the start of an auction should be subject to pre-trade transparency unless they are eligible for a waiver, and whether the practice of locking-in the auction price at the beginning of the auction allows for genuine pre-trade transparency.

According to the final report, ESMA believes that frequent batch auctions systems should provide an appropriate level of disclosure to alert market participants to the commencement of an auction without raising information leakage concerns.^[9] The report notes that ESMA will provide further guidance on this issue.

- *Short auction duration.* The final report finds that despite the short duration of frequent batch auctions, third parties have adequate time to submit trading interest. The report states that “ESMA does not consider necessary taking further action on auction duration at this point.”^[10]
- *Price determination.* The final report addresses three common practices of frequent batch auctions that ESMA believes “may undermine price formation and/or require a reference price waiver”: (1) the use of pegged orders; (2) the use of price band limitations to ensure that an auction’s uncrossing price is always within the European or primary book best bid and offer price; and (3) the practice of locking prices at the beginning of an auction.

The final report finds that all frequent batch auction systems allow the submission of

pegged orders.^[11] ESMA acknowledges that there are advantages to using pegged orders—including certainty of execution—but finds that the regular use of these orders raises doubts about whether frequent batch auctions are price forming. The report notes that “under the current configuration many [frequent batch auction] systems allow the execution of orders at mid-point without the use of a pre-trade transparency waiver as required by” the Markets in Financial Instruments Regulation (MiFIR).^[12] The report expresses the view that frequent batch auction systems “should be genuine price forming systems to operate without the use of a pre-trade transparency waiver. For a system to provide for a genuine price forming mechanism it should be the result of buy and sell interaction and include the possibility for limit orders to interact within the system. ESMA considers that auction systems that only allow the submission of pegged orders and/or adjusted limit orders should only operate under a reference price waiver.”^[13] ESMA notes that it will monitor frequent batch auction systems that do not rely on a reference price waiver to ensure that they do not circumvent the MiFIR/MiFID II pre-trade transparency requirements by employing only pegged orders.

The final report also finds that all frequent batch auction systems use price band limitations to ensure that trades occur within the European or primary book best bid and offer price.^[14] The report notes that these price band limitations can help ensure orderly trading, but finds that “to achieve a meaningful price determination process, price band limitations should not reference to prices determined by other systems.”^[15] The final report further notes that Article 5 of MiFIR imposes the double volume cap to avoid any negative impact on the price formation process and that the “use of price band limitations referencing to prices determined by other systems undermines such objective” and should be under the restrictions of the cap.^[16]

The final report also notes that the practice of locking-in prices at the beginning of an auction may undermine price formation and, especially when used in combination with self-matching functionality, increases the risk that frequent batch auctions will be used for the formalization of pre-arranged transactions. In ESMA’s view, a frequent batch auction system should only lock-in prices at the beginning of the auction if the system allows for the submission of unadjusted limited orders, because this is the only way to ensure that the system will be price-forming. ESMA is considering further clarifying its position through guidance.

- *Self-matching.* The final report finds that all frequent batch auction systems allow for self-matching and broker/member matching preferences, either as a mandatory or an optional feature. This means that it is possible for a member of a frequent batch auction system to match two of its own orders. The report finds that there is no evidence that self-matching functionality is being used to formalized pre-arranged transactions, and ESMA does not have particular concerns about the use of this functionality in frequent batch auctions or other systems at this time. ESMA, however, intends to issue guidance to clarify that self-matching functionality should not be used to formalize trades privately negotiated.

ESMA Commentary on Developments in EU Equity Trading

The final report reviews EU trading data from January 2018 to February 2019 and finds that “the intention of MiFID II of increasing transparency has not been fully achieved.” In particular, the application of the double volume cap mechanism has not increased lit trading. Instead, trading has moved to periodic auctions (including frequent batch auctions and more conventional periodic auctions) and over-the counter.^[17] The report expresses

support for trading venues developing new trading protocols that aim to benefit end investors by increasing execution quality. These new protocols, however, should be “developed in line with the requirements contained in MiFID II, mainly pre-trade transparency and the use of waivers from pre-trade transparency.”^[18]

The report states that ESMA will consider the broader effects of the MiFID II transparency regime in the upcoming MiFID II review. ESMA also plans to consult on over-the-counter trading “in due course.”

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endnotes

^[1] See Final Report: Call for Evidence on Periodic Auctions (11 June 2019), *available at* https://www.esma.europa.eu/sites/default/files/library/esma70-156-1035_final_report_call_for_evidence_periodic_auctions.pdf.

^[2] See Call for evidence: Periodic auctions for equity instruments (9 November 2018), *available at* <https://www.esma.europa.eu/press-news/esma-news/esma-launches-call-evidence-periodic-auctions-equity-instruments>. For a summary of the call for evidence, see ICI Memorandum No. 31501 (28 November 2018), *available at* https://www.ici.org/my_ici/memorandum/memo31501. The “double volume cap” limits the use of two types of pre-trade transparency waivers under MiFID II, the negotiated trade waiver and the reference price waiver. The cap is calculated on a per instrument basis at 4% per venue and 8% market-wide over a 12-month rolling period. After these thresholds are breached, trading under the specified pre-trade transparency waivers is capped. See Call for evidence at 4.

^[3] See Call for evidence, *supra* note 2, at 5 (explaining that while conventional periodic auctions are scheduled by the trading venue, frequent batch auctions are often triggered upon (i) the submission of an order, or (ii) any time a pair of orders can be matched).

^[4] See Final Report, *supra* note 1 at 4-6.

^[5] See Call for evidence, *supra* note 2, at 8.

^[6] See Final Report, *supra* note 1, at 6.

^[7] *Id.*

^[8] *Id.* at

^[9] *Id.* at 8.

^[10] *Id.* at 9.

^[11] See *id.* at 10.

[\[12\]](#) See *id.* at 10.

[\[13\]](#) See *id.* at 11.

[\[14\]](#) See *id.*

[\[15\]](#) See *id.* at 12.

[\[16\]](#) See *id.* at 12.

[\[17\]](#) See *id.* at 14.

[\[18\]](#) See *id.* at 15.

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