

MEMO# 31501

November 28, 2018

ESMA Issues a Call for Evidence on Periodic Auctions for Equity Instruments

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November 28, 2018 TO: Equity Markets Advisory Committee
ICI Global Trading & Markets Committee RE: ESMA Issues a Call for Evidence on Periodic Auctions for Equity Instruments

The European Securities and Markets Authority (ESMA) recently issued a call for evidence on periodic auctions for equity instruments.^[1] The call for evidence is in response to the increased use of frequent batch auctions following the first suspensions of trading under the MiFID II double volume cap.^[2] ESMA plans to use feedback received in response to the call for evidence to further develop its understanding of frequent batch auction trading systems to assess whether and to what extent these systems can be used to circumvent the MiFID II transparency requirements and, if necessary, to develop appropriate policy measures.

Comments on the call for evidence are due by 11 January 2019. ICI Global does not expect to comment on the call for evidence, but **please contact George Gilbert (george.gilbert@ici.org) by December 13 if you would like to share feedback on this consultation.**

MiFID II and Periodic Auctions

For purposes of MiFID II, a periodic auction trading system is “a system that matches orders on the basis of a periodic auction and a trading algorithm operated without human intervention.”^[3] 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 which maximizes the volume of instruments that can be executed.

Although periodic auctions have been used in financial markets for years, a specific type of periodic auction—the frequent batch auction—recently has gained market share. The call for evidence explains that 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.^[4] The call for evidence notes that trading through frequent batch auctions became more pronounced in the European Union beginning in March 2018 when the implementation of double volume caps limited the ability of market participants to rely on certain MiFID II pre-trade transparency waivers.^[5] ESMA asserts that

it “would violate the spirit and the rules of MiFID II” if frequent batch auctions are used to circumvent pre-trade transparency obligations, but notes that the increased use of frequent batch auctions might be driven by other factors, including efforts to reduce the impact of speed and latency on trading in central limit order books.[\[6\]](#)

Review of Frequent Batch Auction Characteristics

The call for evidence seeks input on four characteristics of frequent batch auctions that ESMA believes raise questions about the compatibility of this trading protocol with the MiFID II transparency framework: the application of pre-trade transparency, short auction duration, price determination, and self-matching features.

- **Pre-trade transparency.** To comply with MiFID II’s pre-trade transparency requirement, periodic auction systems, including frequent batch auctions, must make public “the price at which the auction trading system would best satisfy its trading algorithm in respect of [instruments traded on the system] and the volume that would potentially be executable at that price by participants in that system.”[\[7\]](#) The call for evidence questions whether frequent batch auction systems are providing adequate pre-trade transparency in light of this requirement.[\[8\]](#)
- **Short auction duration.** The call for evidence notes that frequent batch auctions typically last from 25-150 milliseconds. Although this short duration might protect market participants from high frequency traders, it also limits the ability of third parties to participate in the auction. The call for evidence seeks input on whether the short duration of frequent batch auctions is appropriate and whether market participants would benefit from a longer auction duration.[\[9\]](#)
- **Price determination.** The call for evidence explains that the uncrossing price that results from a frequent batch auction is set at or within the best bid and offer price. Constraining prices in this manner ensures that prices in frequent batch auctions reflect current market conditions, but this also means that frequent batch auctions have limited utility as price determination mechanisms.[\[10\]](#)
- **Self-matching features.** The call for evidence expresses concern that frequent batch auction systems allow for self-matching, i.e., the matching of two orders from the same member. These self-matching features might facilitate cross-trades that circumvent the limitation on negotiated trades in liquid instruments subject to the double volume cap.[\[11\]](#)

List of Questions in the Call for Evidence

The call for evidence requests feedback on the following questions:

Q1 Do you agree with the two main differences identified to distinguish conventional periodic auctions from frequent batch auctions? If not, please explain why. Q2 Do you agree with the observation of a rising market share for equity trading on frequent batch auctions? Q3 What are in your view the main factors driving this development? Q4 Do you agree with the four characteristics identified by ESMA? Please explain. Q5 Do you consider that other characteristics of frequent batch auctions may explain their success and/or raise questions in terms of compatibility with the MiFID II transparency provisions? Please explain. Q6 What is your view on the level of pre-trade transparency applied by systems that initiate auctions upon the receipt of a first order? In particular, should pre-trade transparency already be applied as of the start of an auction, irrespectively of whether there is a potential match or not? Please explain. Q7 What is your view on the level of pre-trade transparency applied by systems that initiate auctions upon the identification of a possible match? In particular, do you consider that systems locking in prices at the beginning and/or allowing the submission

of orders pegged to the midpoint meet the pre-trade transparency requirements? Please explain. Q8 Would you see benefit in frequent batch auction systems providing information on market/order imbalance? Please explain. Q9 Do you consider the auction length of frequent batch auctions as appropriate? In particular, how does the short auction length contribute to fair and orderly trading? Please explain. Q10 Would you see benefits in having a longer auction duration? Do you consider that the auction duration should take into account the liquidity and/or type of instruments traded (e.g. a longer auction duration for less liquid instruments)? Please explain. Q11 In your experience, how often do frequent batch auctions result in a match, and how many transactions are executed per frequent batch auction on average? Q12 Do you consider frequent batch auction systems as non-price forming systems? Please explain. Should a characteristic of any trading system be that it is always price forming in order to operate without a waiver? Please explain. Q13 Do you consider that these functionalities resemble reference price systems (in particular when matching transaction at mid-point)? Please explain. Q14 How do frequent batch auctions ensure multilaterality and interactions of trading interests in the price formation process (e.g. diversity of participating members, average number of participants, distribution of orders involved per transaction)? Q15 Do you consider that the possibility of pegged orders might weaken the price determination logic? If yes, which measures would you recommend? Q16 How frequently are mechanisms used to prevent an auction uncross at a price outside the EBBO or PBBO (e.g. patterns and occurrences)? Q17 What are your views on self-matching functionalities, and in particular member preferencing, in the context of frequent batch auction systems taking into account their short auction length? Do self-matching functionalities, and in particular member preferencing, coupled with other features of frequent batch auctions (short duration, locked-in prices) contribute to fair and orderly trading? Q18 Do you consider that self-matching functionalities, and in particular member preferencing, on frequent batch auction systems may be used to formalise privately negotiated transactions? Q19 In your opinion, is the feature of member preferencing indispensable for the success observed in frequent batch auction systems since the application of MiFID II? Q20 How do you determine on which execution venues to conclude transactions. Please explain. Q21 Which execution venues attracted the most trading volume following the suspension of dark trading venues under the DVC and why? Please substantiate your answer by quantitative data where available. Q22 Should trading under frequent batch auctions become subject to stricter requirements in the future, to which type of execution venues do you expect the current trading volume under frequent batch auctions to migrate to?

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endnotes

[1] See Call for evidence: Periodic auctions for equity instruments (9 Nov. 2018), *available at* <https://www.esma.europa.eu/press-news/esma-news/esma-launches-call-evidence-periodic-auctions-equity-instruments>.

[2] 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.

[\[3\]](#) See Call for evidence at 4.

[\[4\]](#) See Call for evidence 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).

[\[5\]](#) See Call for evidence at 5-9. Although the use of frequent batch auctions has increased, their share remains fairly modest (less than 3% of volume). Frequent batch auctions have a somewhat larger share of volume in instruments subject to a double volume cap, however.

[\[6\]](#) See Call for evidence at 8.

[\[7\]](#) Call for evidence at 9.

[\[8\]](#) Call for evidence at 9-11.

[\[9\]](#) Call for evidence at 11-12.

[\[10\]](#) Call for evidence at 12-13.

[\[11\]](#) See Call for evidence at 13-14.