



RESPONSE TO ESMA CALL FOR EVIDENCE ON PERIODIC AUCTIONS

Brussels, 11th January 2019

FESE welcomes the opportunity to respond to ESMA's call for evidence on periodic auctions for equity instruments. It is important that regulators and policymakers carefully assess the impact of MiFID II/MiFIR to determine if the regulation is working in line with the legislator's intentions. This type of fact gathering is therefore most welcome.

A key objective of MiFID II/MiFIR is to increase transparency in European financial markets. This objective is intended to be achieved partly by the double volume cap (DVC) introduced for dark equity trading. However, following application of MiFID II/MiFIR, market analyses show that volumes previously traded in the dark have only to a limited extent moved to lit venues and the main shift has been to systematic internalisers, block or large in scale venues and to a small extent also to periodic auctions.¹² FESE shares ESMA's observation that the trend observed for frequent batch auction trading seems to be to a large extent driven by instruments that have been suspended under the DVC and this development should therefore be further assessed. However, while we recognise many of the observations in ESMA's analysis of frequent batch auctions, it should be kept in mind that the market share of periodic auctions is still only around 2 percent for European markets.

As rightly noted by ESMA, trading venues operating auctions is nothing new, on the contrary, auctions are widely used to orderly open and close trading sessions and many venues also organise intra-day auctions. FESE welcomes ESMA's intention to seek advice on the functioning of frequent batch auction systems as this will result in a better understanding of market developments and enable correctly distinguishing between conventional auctions and new frequent batch auctions. Moreover, we would urge ESMA and NCAs to prioritise further investigations and analyses of overall European market structure as it has developed after application of MiFID II/MiFIR and we consider that any consideration of regulatory measures should be based on a thorough analysis of the overall market structure.

¹ T.Cave, 7 August 2018, 'MiFID II: July Heatwave Slows Trading, But Structural Shifts Continue', Tabb Forum, available here: <https://tabbforum.com/opinions/mifid-ii-july-heatwave-slows-trading-but-structural-shifts-continue>

² A.Puaar, 18 October 2018, 'Why MiFID II is missing the mark nine months in', Financial News, available here: <https://www.fnlondon.com/articles/why-mifid-ii-is-missing-the-mark-nine-months-in-20181018>

Q1. Do you agree with the two main differences identified to distinguish conventional periodic auctions from frequent batch auctions? If not, please explain why.

FESE broadly agrees with the two main distinguishing features of frequent batch auctions as identified by ESMA i.e. their limited duration and that they are triggered, not scheduled by the exchange

We do however believe that it is important that those characteristics are considered cumulatively, meaning a frequent batch auction is an auction that has a very limited duration and is triggered.

Please find below a detailed overview of key characteristics of the two types of auctions. Please note that the relevant sections are also included under the more detailed questions asked by ESMA.

Conventional periodic auctions

As noted by ESMA, trading venues traditionally operate both opening and closing auctions. These auctions have a fixed schedule defined by the trading venues and are used to set the price for the beginning and closure of the trading day. Opening auctions are intended to set the first price for the trading day, taking into account the previous trading day, trading activity in other time zones and overnight new information. Closing auctions usually provide settlement and benchmark prices used to evaluate portfolios. The processes are transparent, as the theoretical opening or closing price are continuously published. These auctions are a rally point where liquidity accumulates and a diversity of trading participants interact, thereby ensuring the closing price is as representative as possible of ongoing trading interests. The closing auction on the primary market represents a significant share of trading and remains a centralised, large-scale liquidity concentration event that enables institutional investors to open or close sizeable positions, without undue complexity. In today's highly fragmented markets, the opening and closing auctions are the only time in the day when investors receive the benefit of centralised liquidity, which is critical to price discovery and the stability and transparency of capital markets. The centralisation of liquidity twice a day is what makes opening and closing auctions worthwhile and valuable for investors.

Many exchanges also organise intra-day auctions, e.g. for shares which are not liquid enough for continuous trading and require liquidity to be concentrated to allow trading interests to interact. Traditional auctions therefore provide essential liquidity to the market and contribute to efficient price formation. After a volatility interruption, trading normally also starts in auction mode.

It should be noted that the tick size regime applies to quotes and orders on trading venues, whether these are placed in an auction system or not.

Frequent batch auctions

Due to their specificity, frequent batch auctions can only operate separately from the continuous order book. Frequent batch auctions could be scheduled by the exchange but are usually triggered in different ways, potential crossing orders being the most common. Other triggers can be order submission, or client request.

In terms of transparency, frequent batch auctions only disseminate information when opposing orders are present and during a limited unknown time span usually measured in milliseconds, while traditional auctions typically last several minutes.

As highlighted by ESMA, frequent batch auctions have been criticised for their short duration as it has been questioned whether their set-up allows for multilateral interaction and price formation. Whilst it would be difficult to quantify the necessary minimum duration of an auction, there certainly is a duration which is too limited to allow for the auction's

objectives to be met in terms of multilateral interaction and thus price formation. However, in considering appropriate auction duration, one should also recognise the significant presence of algo trading.

Frequent batch auctions have a very short call phase and mostly reference the price of the most relevant market. Both criteria raise questions regarding the level of price formation taking place on these platforms. However, some frequent batch auctions operated by FESE members do provide price formation restricted by price bands. These auctions allow limit orders, some due to a requirement from the NCAs and some voluntarily, by including an element that breaks the pre-arrangement for a certain price. Other examples are volume maximizing models which then use Broker x Time priority of the eligible orders. In contrast, there are also venues running frequent batch auctions which allow certain broker preferencing which indeed increases the probability for matching of pre-arranged trades.

Under MiFID II/MiFIR rules, pre-arranged transactions are normally hosted under the negotiated deal or reference price waivers, which are both subject to the double volume cap on dark equity trading. Frequent batch auctions are price forming when limit orders are used and an equilibrium price is determined for the maximised volume, within a price corridor generally based on best bid and best offers on other trading venues. However, the price band limitations of frequent batch auctions may result in similar execution as referenced price transactions that are subject to the double volume cap.

FESE understands some venues running frequent batch auctions have a majority of clients using orders pegged at the midpoint and, consequently see a lot of midpoint executions. Any order pegged at midpoint means that some orders are entered in between tick sizes, which we believe was not foreseen by MiFID II/MiFIR for trading venues' lit order books.

Q2. Do you agree with the observation of a rising market share for equity trading on frequent batch auctions?

Yes, FESE agrees with this observation. The market share is however stabilised and relatively modest overall.

Q3. What are in your view the main factors driving this development?

FESE shares ESMA's observation that the trend observed for frequent batch auction trading seems to be to a large extent driven by instruments that have been suspended under the DVC.

Frequent batch auctions allow for executions at midpoint or within the best bid and best offer, which resembles the benefit of trading under the reference price waiver. The limited pre-trade transparency due mainly to the very short auction duration also allows for trades to limit the market impact and information leakage.

In addition, the MiFID II/MiFIR ban on broker crossing networks (BCNs) is another factor driving activity in frequent batch auctions. In the new regulatory environment, systematic internalisers and frequent batch auctions with low price impact and internalisation capabilities target a market segment previously executed on BCNs.

Finally, it can be argued that frequent batch auctions, and in general periodic auctions, reduce the importance of speed and latency. This aspect is mentioned by the FCA in their recent analysis where they argue that "market participants who do not have access to superfast trading technology (for example servers located in the same building as those of the exchange operator, direct fibre optic or microwave connections between different trading locations) are less at risk of losing out to those who do." Periodic auctions would

then establish a more level playing field between market participants.³ While we could support this general argument, we would encourage regulators to balance this aspect against other key aspects specific to frequent batch auctions as regards liquidity aggregation and price formation (broker preference, trigger mechanism, duration) which should not be neglected.

FESE welcomes ESMA assessing this issue and considers it important that European supervisors have a common approach to ensure a level playing field.

Q4. Do you agree with the four characteristics identified by ESMA? Please explain.

Yes, FESE agrees with the four characteristics identified by ESMA. Please see below an overview of the main differences between conventional and frequent batch auctions in relation to these areas.

	Conventional Auctions	Frequent batch auctions
Is price formation taking place?	Yes, conventional auctions centralize liquidity to provide price discovery at the start and end of trading or when trading resumes after a volatility interruption.	Reduced price formation where the orders may only be pegged at midpoint or where there is price band limitations. In other set-ups, yes.
What levels of transparency are provided?	Regulated by RTS 1. Indicative matching price and indicative matching volume are published during the call phase. Some European exchanges willingly publish the full order book. Subject to full post-trade transparency.	Regulated by RTS 1. Indicative matching price and indicative matching volume are published during the call phase. Certain minimum pre-trade transparency provided during a very short time-frame measured in milliseconds. Subject to full post-trade transparency.
What criteria can be used for matching priority?	Price x Volume x Time, in some cases also member priority ⁴ .	Combinations of broker, price, volume and time dimensions.

³ FCA, 'Periodic auctions', 28 June 2018, available here: <https://www.fca.org.uk/publications/research/periodic-auctions>.

⁴ Not all venues allow member priority.

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.

Frequent batch auctions put in place by various market operators across the EU display some different features, such as in pegging of orders, off-tick matching, member preferencing, frequency, triggering and duration time. Depending on how such features are combined, not only may the level of transparency vary, but also the degree of multilateralism and price formation. This also raises questions from a level playing field perspective.

Off-tick matching might in part explain the success of frequent batch auctions as tick sizes are respected only at order entry by individual participants, and not respected at all if orders are pegged to the midpoint. This means that frequent batch auctions may execute transactions in between ticks, thus enhancing their ability to improve prices in contrast with Regulated Markets and MTFs which are required to respect tick size regimes from order entry to execution.

We note that under MiFID II/MiFIR rules, transactions executed at the midpoint on trading venues are normally hosted under the negotiated deal or reference price waivers, which are both subject to the double volume cap on dark equity trading.

We would therefore encourage ESMA and NCAs to find converging approaches to the enforcement of MiFID II/MiFIR provisions as regards frequent batch auctions.

Overview differences between conventional auctions and frequent batch auctions

	Conventional Auctions	Frequent Batch Auctions
How are the auctions triggered?	Auctions are scheduled by the exchange.	Several possible triggers: <ul style="list-style-type: none"> • When there are potential crossing orders present. • Changes in the order book • On request • Time triggers (can be random)
What order types are allowed?	Limit orders, market orders, stop orders.	Limit orders, market orders, PBBO pegged limit orders, midpoint pegged orders.
Do orders need to fulfil minimal size requirements?	No.	Certain venues apply minimum sizes.
Does the auction system operate in accordance with the tick size regime?	Yes.	Yes, for orders entered. No, for executions - some periodic auctions venues authorise sub-ticks for midpoint matching (within price band limitations).

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.

Pre-trade transparency needs to be in place long enough for multiple participants to be able to join the auction and thus ensure multilateral trading.

There would be detrimental and severe risk for information leakage if order imbalance information would be published at entry of the first order. The reason is that if a large trading interest is published, for instance a large buy order imbalance, this could most likely drive the price in the lit market, hence giving a large price impact. Our view is that when crossing orders have been entered and an auction has started, the indicative price and volume shall be published.

This is also important from another standpoint, where traders typically want to protect their orders with Minimum Acceptable Quantity (MAQ) or Minimum Execution Size (MES) features. In other words, they might have entered a very large order with an MES, meaning that any imbalance information may be misleading, since in order to initiate an auction at least the opposite size equal to MES needs to be entered as an opposite order.

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.

FESE understands that frequent batch auctions that initiate auctions upon the identification of a possible match do provide real-time information on the indicative price and volume from the beginning of the auction. As mentioned by ESMA, the value of information provided is however limited since some frequent batch auctions allow only for auction price within or at the primary bid and offer (PBBO) and start the auction with a locked price, resulting in a pure volume auction with a limited if not non-existing contribution to the price discovery.

Locking in prices at the beginning of an auction does not allow for price formation and should not be allowed. However, a distinction should be made between frequent batch auctions that lock in prices and those that lock in orders where the latter contribute to volume discovery.

Q8 Would you see benefit in frequent batch auction systems providing information on market/order imbalance? Please explain.

No, FESE does not see benefit in frequent batch auction systems providing information on market/order imbalance. Providing such information would lead to a price impact showing the imbalance, which would not work together with Minimum Acceptable Quantity and Minimum Execution Size features.

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.

FESE considers that it is difficult to quantify a necessary minimum duration of an auction. However, there certainly is a duration which is too limited to allow for the auction's objectives to be met in terms of multilateral interaction and price formation. If the duration is too short, or if the transparency only applies at the very end of an auction, it does not seem appropriate. However, in considering appropriate auction duration, one should also recognise the significant presence of algo trading.

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.

FESE considers that there may be benefits to introducing a certain auction duration in order to ensure multilateral trading. However, if regulators were to consider doing so, it would be important to distinguish between a) auctions where the duration starts when there is a trigger in the form of matching orders, and b) auctions that starts before there are matching orders.

The former type of auction allows other participants to join, thereby ensuring multilateral trading. However, auctions where the duration starts before there are matching orders (and the auction is non-displayed until there is a match) do not ensure multilateral trading. This is because, where there is a match only at the very end of the auction, other participants do not have a realistic chance to join.

FESE does not consider that the auction duration should take into account the liquidity and/or the type of instruments traded since this would add complexity and there are no obvious benefits. For the case of less liquid instruments a significantly longer auction duration might not be beneficial. In particular, this could apply to illiquid stocks where liquidity is so scarce that the price discovery might deteriorate with a long duration and large price fluctuations.

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?

N/A

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.

FESE considers that there is reduced price formation where orders may only be pegged at midpoint or where there is price band limitations. In other set-ups, or when the pegging of orders is combined with other features, there can however be price formation in frequent batch auctions.

Q13 Do you consider that these functionalities resemble reference price systems (in particular when matching transaction at mid-point)? Please explain.

Under MiFID II/MiFIR rules, pre-arranged transactions and transactions executed at midpoint on trading venues are normally hosted under the negotiated deal or reference price waivers, which are both subject to the double volume cap on dark equity trading. Frequent batch auctions are price forming when limit orders are used and an equilibrium price is determined for the maximised volume, within a price corridor generally based on best bid and best offers on other trading venues. However, the price band limitations of frequent batch auctions results in similar execution as reference price transactions that are subject to the double volume cap.

FESE understands some venues running frequent batch auctions have a majority of clients using orders pegged at the midpoint and, consequently see a lot of midpoint executions. Any order pegged at midpoint means that some orders are entered in between tick sizes, which we believe was not foreseen by MiFID II/MiFIR for trading venues' lit order books.

Depending on their set-up, frequent batch auctions can resemble reference price systems. However, if implemented in a way that ensures transparency, multilateral trading and price formation (see first paragraph above and response to Q14), frequent batch auctions differ from reference price systems, which are indeed dark and do not contribute to price formation.

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)?

Price formation and multilateral trading can be ensured by the duration of an auction being long enough for participants to join the auction and react and interact. A sufficient pool of market participants brings different trading interests, which participate in the price formation process if the auction is based on limit orders and the auction algorithm on the maximisation of the executable volume.

Moreover, a price formation process can only take place on systems where the auction is triggered once the order book is crossed with orders on both sides of the book - not just one order - which also allows for pre-trade transparency via the publication of the indicative price and executable volume.

Q15 Do you consider that the possibility of pegged orders might weaken the price determination logic? If yes, which measures would you recommend?

Frequent batch auctions have a very short call phase and mostly reference the price of the most relevant market. FESE considers that both criteria raise questions regarding the level of price formation taking place on these platforms.

However, some frequent batch auctions provide price formation restricted by price bands. These auctions allow limit orders, some due to a requirement from the NCAs and some voluntarily, and if the limit order has a bigger volume than the pegged order the limit order wins. This means there can be an element that breaks the pre-arrangement for a certain price.

FESE welcomes ESMA assessing this issue and considers it important that European supervisors have a common approach to ensure a level playing field.

Q16 How frequently are mechanisms used to prevent an auction uncross at a price outside the EBBO or PBBO (e.g. patterns and occurrences)?

N/A

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?

FESE considers that Broker x Price x Volume x Time priority models can be used for pre-arranged trading. However, while preferencing may increase the likelihood of an internal trade it does not automatically mean it always leads to an internal trade. It should also be noted that some conventional auctions apply broker priority but the effect also depends on other applicable features of the auction in question.

Some venues running frequent batch auctions change the allocation priority from 'Price x Volume x Time' to 'Broker x Price x Volume x Time' for all orders submitted with broker priority and this type of broker preferencing allows for the matching of pre-arranged trades.

Under MiFID II/MiFIR rules, pre-arranged transactions are normally hosted under the negotiated deal or reference price waivers, which are both subject to the double volume cap on dark equity trading.

Frequent batch auctions are price forming when limit orders are used and an equilibrium price is determined for the maximised volume, within a price corridor generally based on best bid and best offers on other trading venues. However, the price band limitations of

frequent batch auctions results in similar execution as referenced price transactions that are subject to the double volume cap.

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?

FESE considers that Broker x Price x Volume x Time priority models can be used for pre-arranged trading. However, while preferencing may increase the likelihood of internal trade it does not automatically mean it always leads to an internal trade and this is also dependent on other features of the auction in question.

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?

FESE does not have information on this but would encourage ESMA to carefully assess the issue.

Q20 How do you determine on which execution venues to conclude transactions. Please explain.

N/A

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.

N/A

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?

Should regulators consider subjecting frequent batch auctions to stricter requirements, it is important to structure such requirements in a way that does not inadvertently incentivize a move of trading to less transparent execution venues.

There is otherwise a significant risk that trading volumes would go to dark venues that are less transparent than frequent batch auctions and volumes could also move to bilateral trading in systematic internalisers that are subject to less transparency requirements. This would lead to overall less transparency in European equity markets, which should be avoided.

About us:

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