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# ESMA Call For Evidence: Periodic Auction for Equity Instruments

## ITG response and analysis

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On 9 November 2018, the European Securities and Markets Authority (ESMA) published a call for evidence on periodic auctions for equities, from which it would assess whether systems for a periodic auction—or “frequent batch auction” (FBA)—operate within the spirit and the rules of MiFID II.

The deadline for consultation responses was Friday, 11 January 2019, and the responses were made public on Thursday, 17 January. Responses are available [here](#).

In addition to publishing its own response to the consultation, ITG has analysed the public responses from other participating firms and industry associations. The methodology for this analysis was to classify each respondent into one of five categories reflecting its position within the industry. These are summarised in the following table. We then evaluated their responses in the context of four key themes contained within the consultation: the level of price formation in periodic auctions; the impact of pegged orders on price formation; the amount of information disclosed during an auction; and the length of an auction. We also assessed respondents’ opinions for or against the inclusion of broker prioritisation within auctions. For each theme we constructed statements against which each response was scored.

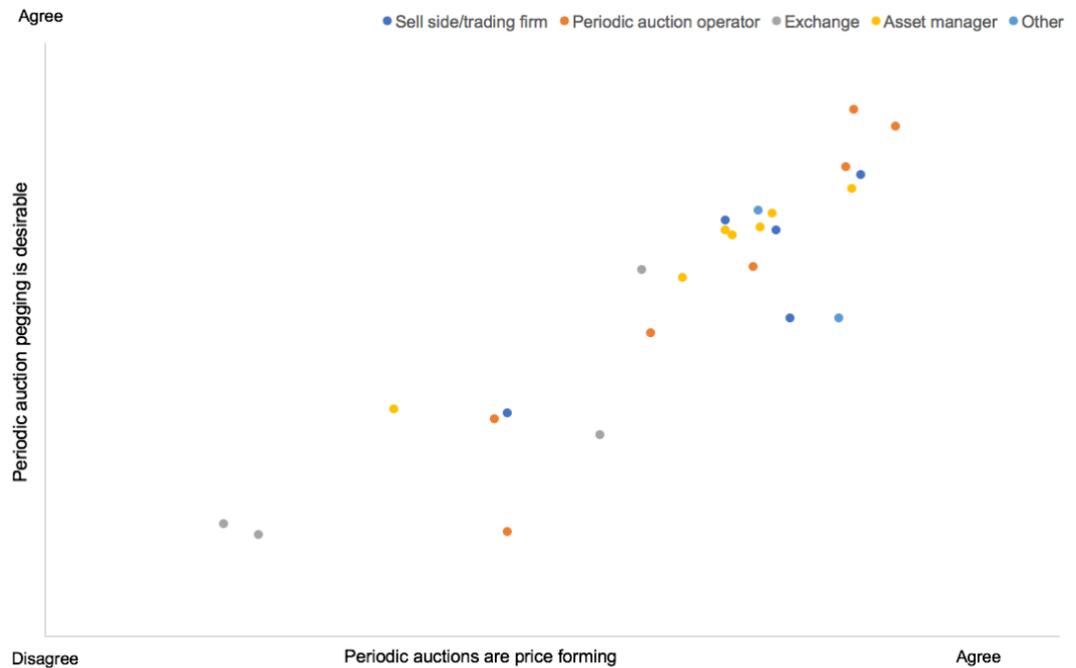
**Categories of Respondents**

<b>Chart Key</b>	<b>Industry Position</b>
Sell-side	Sell side/trading firm/sell-side association
Periodic Auction Operator	Operator of periodic auction book
Exchange	Exchange, exchange regulator or exchange association
Asset manager	Asset manager/asset management association
Other	Academic/research or miscellaneous

Source: ITG

## PRICE FORMATION AND PRICE PEGGING

### Views on Price Pegging vs. Price Forming in Periodic Auctions



Source: ITG analysis of responses to ESMA periodic auction consultation

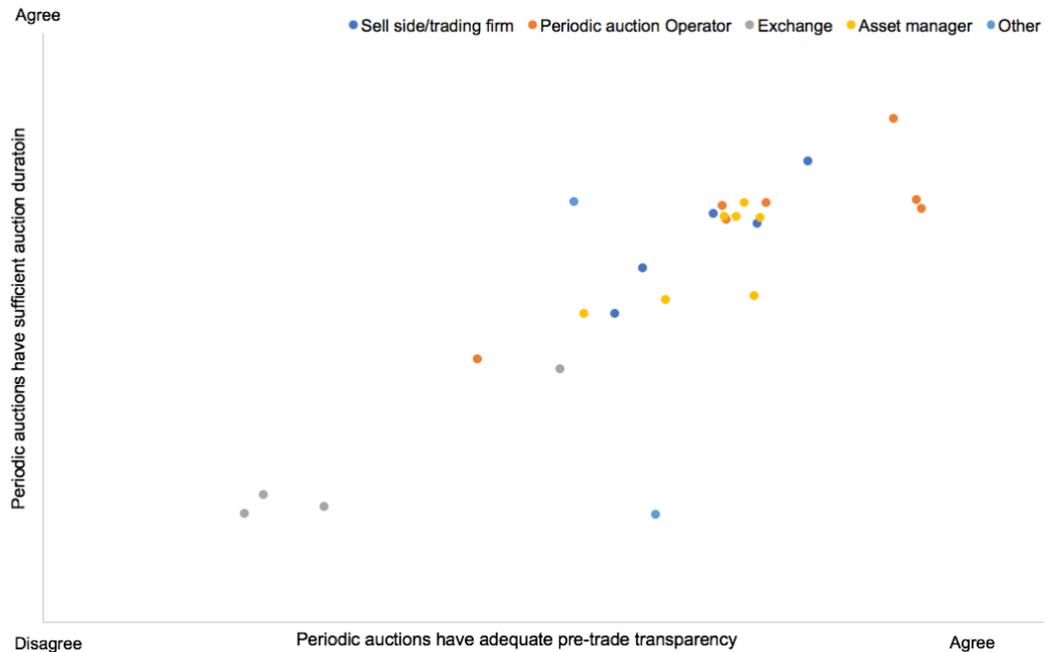
As the chart shows, and as might be expected, the opinion on the price-forming nature of periodic auctions diverges based on the type of firm responding to the consultation. Buy-side and sell-side firms, along with operators of periodic auctions, were mainly supportive of the position that periodic auctions are price forming and contribute to price formation. The contra position is largely taken by the exchanges/exchange regulators or associations and certain others. The core of their argument appears to be that executions involving pegged orders are simply not price forming on the basis that the price is derived from another system.

Interestingly, one of the clearest arguments in favour of pegged orders being price forming and contributing to price formation comes from a proprietary trading firm, Optiver, which while active in conventional auctions, says that it does not participate in FBAs. Its response stated that “trades in an auction reflect an agreement between buyers and sellers on the value of a security. Especially when a large amount of volume is matched at a certain price, this is very relevant information for the valuation of that security by other investors. Thus, we feel that frequent batch auctions can be price forming, even when they uncross at mid-point, just like conventional auctions.”<sup>1</sup>

<sup>1</sup> <https://www.esma.europa.eu/file/49984/download?token=89li0ZO3>

## PRE-TRADE TRANSPARENCY AND AUCTION DURATION

### Views on Periodic Auction Duration and Pre-Trade Transparency



Source: ITG analysis of responses to ESMA periodic auction consultation

With a few exceptions, most respondents argued that the indicative price and volume provided by periodic auctions to meet their transparency obligations were sufficient and that additional information would have negative consequences in information leakage and impact costs, given that periodic auctions trade while continuous markets are open, in contrast to conventional auctions. Notably, the Federation of European Securities Exchanges (FESE) represented this position, stating: “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”.<sup>2</sup> Most firms also recognised that, in today’s markets, algorithmic trading plays such a large role and modern trading systems are sufficiently fast that the length of auction duration gave market participants plenty of time to respond.

Surprisingly, a case for a regulated minimum auction duration for FBAs was made by Deutsche Börse Group with the claim that “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”.<sup>3</sup> One assumes that, as noted by a number of the respondents, any such minimum duration requirement would also apply to Central Limit Order Books, such as those operated by Deutsche Borse. Interestingly, the view that the German exchange group expressed is further complicated by the responses of certain representatives of the German investment firm community. Bundesverband der Wertpapierfirmen suggested that “if ESMA should come to the conclusion that frequent batch auctions give raise to regulatory concern and in particular a minimum overall auction length should be prescribed, **such active intervention in markets would necessitate a recast of Level 1 [framework legislation]** and could and should not be addressed by changes to the proven market typology in table 1 of Annex I of RTS 1”<sup>4</sup>. Those with good memories will recall that a minimum order duration for lit markets was put forward by the European Parliament in the early stages of MiFID II, and was one of the few proposals that faced near unanimous opposition from all actors in the markets.

<sup>2</sup> <https://www.esma.europa.eu/file/50022/download?token=K-OFa2z4>

<sup>3</sup> <https://www.esma.europa.eu/file/50014/download?token=WUKU9xIP>

<sup>4</sup> <https://www.esma.europa.eu/file/50026/download?token=qaaTLxTt>

## MEMBER OR BROKER PREFERENCING AND SELF-MATCHING

Member preferencing was another key theme that responses were evaluated against. UBS reinforced the distinction that “broker preferencing is not a self-matching functionality. It is broker preferencing, but not broker certainty”.<sup>5</sup> Several firms emphasised that similar functionality was offered across different venue types and was not unique to periodic auctions. BlackRock recommended “equal treatment and a level playing field, whether self-matching occurs on an exchange or elsewhere”,<sup>6</sup> and several of the responses highlighted the cost advantages that accrue to end investors.

While no firm said that broker preferencing was essential for the success of periodic auctions, responses indicate that, if this feature were to be removed, it could result in greater fragmentation, with liquidity migrating to less pre-trade transparent venues and an increase in the frictional costs of trading.

## BENEFITS OF PERIODIC AUCTIONS

The ESMA call for evidence did not specifically ask firms to outline the benefits of using periodic auctions. However, many respondents either provided evidence using their own assessment of the benefits or cited studies by various firms that primarily show the reduced price movement occurring around trades undertaken in periodic auctions. In this context, the response of Deutsche Börse Group stood out in stating that “**the market impact, information leakage and order size do not appear to be the motivation to trade on FBAs**”,<sup>7</sup> thereby putting itself at odds with the opinions expressed by both its direct sell-side members and institutional investors.

## RESPONSE CONSENSUS OR COORDINATED RESPONSES?

In some cases we identified highly consistent and in some cases identical language being used across the responses from a single category of respondents. This could suggest that certain firms actively coordinated their responses prior to submission. We hope that the resulting duplication in certain responses will not diminish the value of the exercise for ESMA and we certainly trust that such coordination does not lead to greater weight being attributed to any duplicated responses.

## CONCLUSION ON RESPONSES TO CALL FOR EVIDENCE ON PERIODIC AUCTIONS

In multiple responses, firms suggest that the data currently available is insufficient to determine if the activity in periodic auctions has a causal link to the implementation of the double volume caps. Firms highlight that, because periodic auctions make up such a small percentage of the market, the link is difficult to establish and more data should be obtained over a longer period. This feedback was largely consistent across the five respondent categories. One exchange operator, Bolsas y Mercados Españoles, specifically requested that “any consideration of regulatory measures should be based on a thorough analysis of the overall market structure”<sup>8</sup>—a response, one assumes, to any intention by ESMA to propose new measures based on this assessment alone, which is limited to activity in periodic auctions.

<sup>5</sup> <https://www.esma.europa.eu/file/50004/download?token=ZBJmSBMj>

<sup>6</sup> <https://www.esma.europa.eu/file/50002/download?token=83Q521Xw>

<sup>7</sup> <https://www.esma.europa.eu/file/50014/download?token=WUKU9xIP>

<sup>8</sup> <https://www.esma.europa.eu/file/50007/download?token=QVKbrOG0>



## ITG'S VIEW

We believe that Periodic Auctions are an excellent innovation born of a regulated environment that places a greater onus on transparency. The beneficial impact on trading performance delivered by periodic auctions has led to the adoption of these venues by banks and brokers providing algorithmic execution services so they may provide best execution to their clients, rather than out of any intention to contravene the DVC restrictions.

In addition to this summary, we provide full details of ITG's responses interwoven with the original text of the call for evidence within this [document](#).

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