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What Next for Periodics?

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What Next for Periodics?

ESMA has now published its views on the future of periodic auctions and the steps it intends to take based on the call for evidence issued in November 2018[1]. As we noted in Liquidity Landscape[2] rather than ruling Periodics out in their entirety, ESMA is looking for greater consistency and clarity over individual auction constructs to ensure that these are not being used to circumvent the Double Volume Cap (DVC). This is good news for the buy-side as periodics have become a valuable construct in minimising market impact and thereby reducing unnecessary execution costs but the question is the extent to which ESMA plans to restrict activity.

The perceived lack of pre-trade transparency and price discovery in certain types of periodics – Frequent Batch Auctions (FBA) rather than conventional periodic auctions – is where ESMA is focusing their attention. FBAs often have a shorter duration of milliseconds and can be triggered sporadically rather than being scheduled by a trading venue; and secondly, in relation to price formation, the use of EBBO price collars and pegged orders can – in ESMA's opinion- constrain full true price formation.

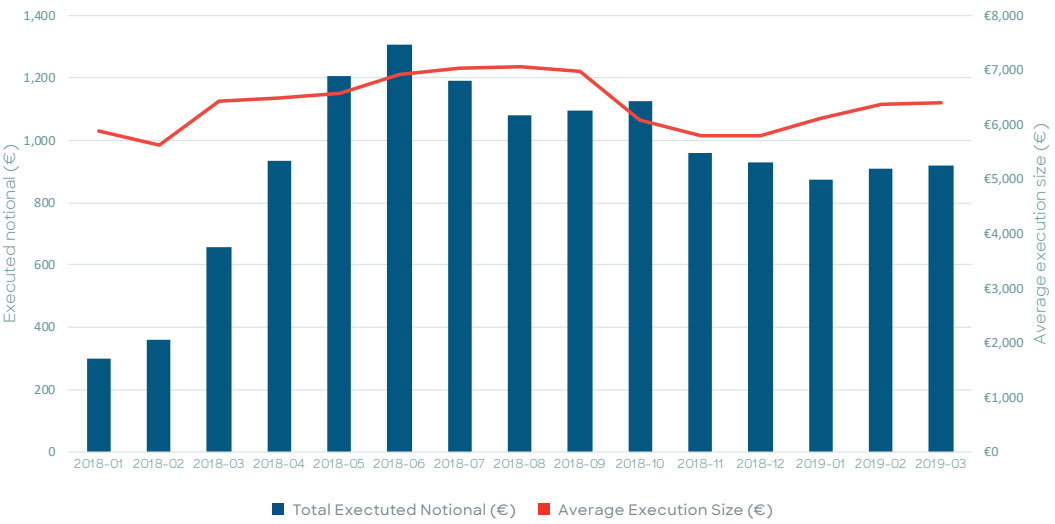
The DVC Issue

ESMA data indicates that FBA trading increased after the first implementation of the DVC, from 0.5% in January 2018 to 2.4% in August 2018, and then after the first suspensions expired in September, there was a decline in market share (see Exhibit 1). While FBA activity has subsequently stabilised overall (see Exhibit 2).

Exhibits 1 and 2: Development of trading on frequent batch auctions / Periodic Auction activity

Note: Evolution of the frequent batch auction trading share in total trading, in %.

Source: ESMA

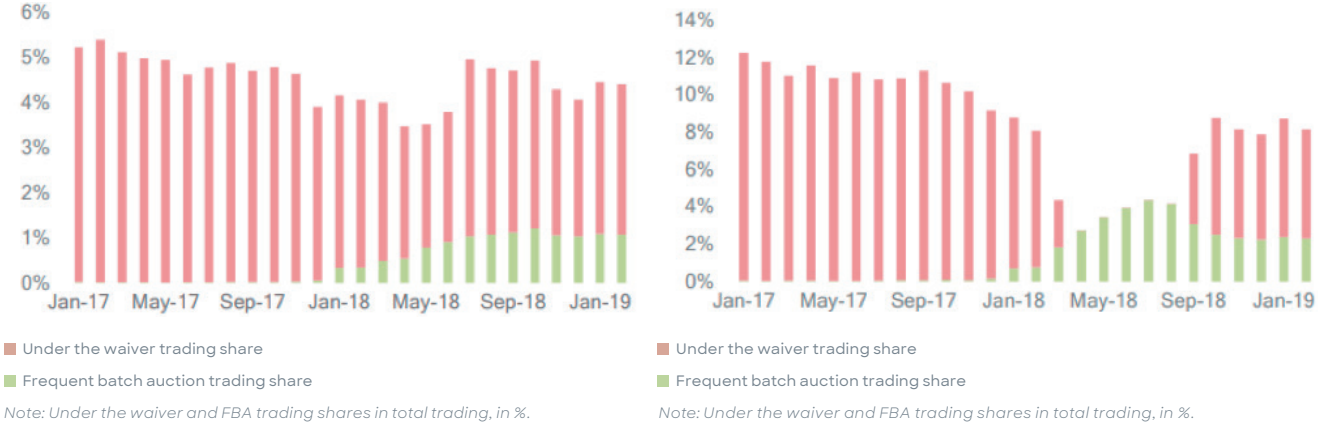


Source: Bloomberg

[1] https://www.esma.europa.eu/sites/default/files/library/esma70-156-1035_final_report_call_for_evidence_periodic_auctions.pdf
[2] https://static1.squarespace.com/static/5bedbc974eddecbfbb0c217e/t/5c6c7f294e17b614db7ee44a/1550614314708/Liquidnet+Liquidity+landscape+-+Q4+2018+-+2.19.2019.pdf

ESMA's concern remains that for ISINs suspended under the DVC in March 2018, FBAs accounted for less than 1% of overall trading in January 2018 but reached 4.35% in July 2018 and following the end of the suspension period in September 2018, the trend inverted with an immediate drop to 3.05% in September before reaching 2.28% in February 2019 (see Exhibit 3).

Exhibit 3: Development of trading on frequent batch auctions and under waivers subject to the DVC –ISINs that were never subject to a DVC suspension (left) and ISINs that were subject to a suspension and for which the suspension ended in September 2018 (right)



Note: Under the waiver and FBA trading shares in total trading, in %.

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Sources: ESMA

The question is does this matter? Market participants believe the current debate is misleading as the reason for the success of FBAs is the ability to execute at the mid-point and protection from high frequency trading which optimises best execution performance once the ability to trade in the dark has been constrained. However, for the European regulator this issue is at the crux of MiFID II and the objective to increase transparency in equity markets. Hence the need to ensure FBAs are in line with MiFID II legislation and not used as a means to circumvent the regulatory intent.

Milli-second Timeframes

As required by MiFID ll, all frequent batch auction systems have pre-trade transparency as they publish indicative price and size prior to an auction as per MiFID II RTS 1. Most opening and closing auctions publish full order book depth and some include order book imbalance which can result in unnecessary information leakage. However, different FBA constructs apply pre-trade transparency requirements in different ways, depending on whether the systems initiate an auction at the arrival of the first order, or when a matching opportunity occurs. As the timeframe in which they publish these prices can sometimes only be a matter of milliseconds as well as variable, some respondents in relation the ESMA's call for evidence noted that the technological capability to capture this information creating an unlevel playing field. For others, the same point could be noted for lit continuous markets given the speed of trading today.

True Price Formation

The use of mid-point crossing in periodic auctions without the use of any pre-trade transparency waiver is of concern for ESMA as – in their view – this does not comply with MiFIR but is merely using a reference price from other markets which should require the use of the RPW and would therefore be subject to the DVC. The call for evidence raised concerns whether orders submitted pending the start of an auction[3] should be subject to pre-trade transparency unless benefitting from a waiver, and whether the practice of locking-in the auction price at the beginning of the auction, in particular in combination with the practice of pegging orders, allows for genuine pre-trade transparency. Most FBA accept pegged orders to either the bid, mid-point or offer to offer certainty of execution but responses from the Q&A highlight that FBAs which *"do not allow the submission of limit of market orders, should be considered as non-price forming and a way to circumvent the DVC, thus undermining the price formation process"*[4]. The concern that these systems are not true price forming systems was reinforced by ESMA's analysis of the EUROSTOXX 50 which showed limiting price movements within the EBBO prevents price formation. Although the benefit of price band limitations was recognised, ESMA wants to ensure meaningful price determination and avoid undermining the restrictions of the DVC by proposing that auctions should accept unadjusted limit and market orders particularly those that lock in prices at the start of the call period. The challenge for the industry is that the use of price collars is a common functionality as it facilitates trades being executed at current price levels, preventing their use will require alternative means to ensure consistent price formation. This poses an issue for those brokers who have restructured dark strategies to periodics, as the ability to use collars has let them do this with little to no risk. Without the collars, prices are not guaranteed to be within the EBBO, and brokers may need to re-consider routing mechanisms as a result.

What Next?

ESMA intends to issue further supervisory guidance in the coming months on the following areas[5];

1. When an Auction is taking place – while ESMA acknowledges market operators should be free to decide which type of system they intend to operate, users of the system need to be aware when an auction has started and ESMA intends to provide further guidance on the information required to allow participants to contribute in the auction while at the same time not requiring excessive pre-trade transparency which could lead to information leakage.

2. Ensuring meaningful price determination – ESMA intends to monitor the use of how price formation occurs. This will be one to watch given their comments in relation to price formation listed above.

While concerns about periodic auctions clearly still remain, for the UK regulator there is still a lack of consistent data over a sufficient time period to make concrete decisions at this stage. Research undertaken by the FCA concludes there is little difference between the increase in volumes of periodic auctions pre-MiFID for shares where dark trading is still allowed thus suggesting MiFID II's dark trading requirements are not solely responsible for the increase in periodic auctions. The view of the FCA is that if the DVC is resulting in trading shifting from the dark to periodic auctions, there would be a larger increase in the number of shares subject to dark trading bans then there currently is (see Exhibit 4)[6].

Exhibit 4: Average daily trade volume for each timeframe and equity type, CBOE periodic auctions, FTSE350 equities.

	Before 3 January 2018 Pre-MiFID II	3 January – 11 March 2018 Pre-DVC	From 12 March 2018 Post-DVC
Capped	£0.62m	£9.0m	£30.9m
Uncapped	£0.28m	£3.2m	£10.1m

Source: FCA, Thomson Reuters Tick History

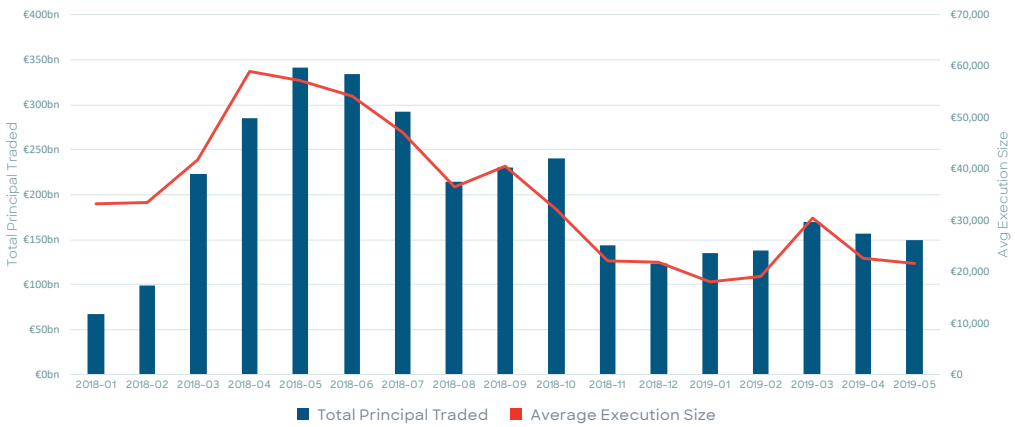
[3] https://www.esma.europa.eu/sites/default/files/library/esma70-156-1035_final_report_call_for_evidence_periodic_auctions.pdf
[4] https://www.esma.europa.eu/sites/default/files/library/esma70-156-1035_final_report_call_for_evidence_periodic_auctions.pdf
[5] https://www.esma.europa.eu/sites/default/files/library/esma70-156-1035_final_report_call_for_evidence_periodic_auctions.pdf
[6] https://www.fca.org.uk/publications/research/periodic-auctions

One to watch

While MiFID II may have had the intention of increasing transparency, it is clear that this has not been fully achieved to the extent ESMA required, given that the introduction of the DVC has moved trading to Periodic auctions and OTC (SIs) rather than increased lit trading in the EU. ESMA also notes however that they acknowledge the removal of periodic auctions is unlikely to result in a shift of volumes to the lit market[7]; other constructs such as Request for Quote (RFQ) models are using similar constructs and as a result liquidity will continue to shift away from the lit.

The same concerns relate to the increase in SI activity. While SI activity has stabilised of late after a steep decline in the second half of 2018 and early 2019 with the amount executed on these venues decreasing to an averaging low of €6.1bn in January, activity picked up again to reach €10.6bn in March (see Exhibit 5). The drop in activity coincided with a continued fall in the average fill size to ~21.0k EUR in May, rising again to 30.5k EUR as activity increased at the end of the quarter (Exhibit 5). The European Commission's amendment[8] to subject SIs to the tick size regime for standard trade sizes will restrict their ability to price improve, the recent analysis of RTS 28 reports[9] show a clear prevalence for certain bulge broker SIs to execute order flow on their internal Sis rather than regulated markets which is also likely to incur further regulatory scrutiny.

Exhibit 5: Systematic Internalisers activity



Source: Rosenblatt Securities & Bloomberg

Although this is likely to trigger further regulatory intervention, if the requirement is to ensure greater transparency in market activity, there are potentially other ways to address this issue. The provision of more accurate post trade data could provide sufficient post-trade transparency as to what has traded where, regardless of the venue or the order type used. Should the regulator choose to mandate the use of industry standardised FIX MMT tagging, addressable and non-addressable liquidity will be more clearly identifiable, providing better visibility into market activity. The greater the visibility, the more likely buy-side will trade where they believe they will achieve best execution.

If on the other hand, the regulators want to see further support of continuous lit trading, ESMA will need to find an alternative means of changing market behaviour. Merely restricting non-continuous lit liquidity – via periodics or use of SIs is more likely to lead to the emergence of further alternative market innovations rather than volumes moving back to the lit. Improved transparency of trading and increasing trading on continuous lit venues are two separate regulatory requirements. Improved transparency is possible today; trading on lit continuous markets in the manner the regulator expects is far more complex and we are likely to see further market innovation as participants continue to see the benefits of trading in the dark rather than switch back to the lit.

[7] https://www.esma.europa.eu/sites/default/files/library/esma70-156-1035_final_report_call_for_evidence_periodic_auctions.pdf
[8] http://ec.europa.eu/finance/docs/level-2-measures/mifir-delegated-act-2018-8390_en.pdf
[9] https://static1.squarespace.com/static/5bedbc974eddecbfbb0c217e/t/5ce58fe824a694ac12dfb084/1558548456385/LNU+What%27s+Next+For+Best+Ex+DIGITAL.pdf

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Rebecca is considered to be one of Europe's leading industry voices on market structure, regulatory reform, and financial services technology. She has authored a plethora of qualitative research reports and commentary covering the impact of market regulation on all asset classes, changing market structure and developments in dark pools, HFT, and surveillance. She joined Liquidnet in July 2016 to use her 20 years' experience to collaborate and deliver research and insights for both the European equities and fixed income markets. Rebecca is also Co-Chair of the FIX Trading Community's EMEA Regulatory Subcommittee, dedicated to addressing real business and regulatory issues impacting multi-asset trading in global markets. She has held prior roles at TABB Group, Incisus Partners, the British Embassy in Bahrain, Credit Suisse, Goldman Sachs International, and Bankers Trust International.

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Charlotte joined Liquidnet in May 2017 to work with Rebecca Healey on EMEA market structure and deliver research and insights about the European financial markets. Charlotte joined from Reed Exhibitions where she was a mergers and acquisitions analyst. Prior to Reed Exhibitions, Charlotte held a role at The Boston Company Asset Management in Boston.

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