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| 9 November 2018 |

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| Reply form for the call for evidence - Periodic auctions for equity instruments |
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| Date: 9 November 2018 |

Responding to this paper

The European Securities and Markets Authority (ESMA) invites responses to the specific questions listed in the Call for evidence on periodic auctions on equity instruments published on the ESMA website.

*Instructions*

Please note that, in order to facilitate the analysis of the large number of responses expected, you are requested to use this file to send your response to ESMA so as to allow us to process it properly. Therefore, ESMA will only be able to consider responses which follow the instructions described below:

* use this form and send your responses in Word format (pdf documents will not be considered except for annexes);
* do not remove the tags of type <ESMA\_QUESTION\_CFE\_PA\_1> - i.e. the response to one question has to be framed by the 2 tags corresponding to the question; and
* if you do not have a response to a question, do not delete it and leave the text “TYPE YOUR TEXT HERE” between the tags.

Responses are most helpful:

* if they respond to the question stated;
* indicate the specific question to which the comment relates;
* contain a clear rationale; and
* describe any alternatives ESMA should consider.

**Naming protocol**

In order to facilitate the handling of stakeholders responses please save your document using the following format:

ESMA\_CFE\_PA\_NAMEOFCOMPANY\_NAMEOFDOCUMENT.

e.g. if the respondent were ESMA, the name of the reply form would be:

ESMA\_CFE\_PA\_ESMA\_REPLYFORM or

ESMA\_CFE\_PA\_ESMA\_ANNEX1

***Deadline***

Responses must reach us by **11 January 2019.**

All contributions should be submitted online at [www.esma.europa.eu](http://www.esma.europa.eu) under the heading ‘Your input - Consultations’.

***Publication of responses***

All contributions received will be published following the end of the consultation period, unless otherwise requested. **Please clearly indicate by ticking the appropriate checkbox in the website submission form if you do not wish your contribution to be publicly disclosed. A standard confidentiality statement in an email message will not be treated as a request for non-disclosure.** Note also that a confidential response may be requested from us in accordance with ESMA’s rules on access to documents. We may consult you if we receive such a request. Any decision we make is reviewable by ESMA’s Board of Appeal and the European Ombudsman.

***Data protection***

Information on data protection can be found at [www.esma.europa.eu](http://www.esma.europa.eu) under the headings ‘Legal notice’ and ‘Data protection’.

# General information about respondent

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| --- | --- |
| Name of the company / organisation | Plato Partnership Ltd |
| Activity | Other Financial service providers |
| Are you representing an association? |[x]
| Country/Region | Europe |

# Introduction

Please make your introductory comments below, if any:

<ESMA\_COMMENT\_CFE\_PA\_1>

Plato Partnership is a not-for-profit company comprising 24 European buy-side and sell-side member firms and was established in September 2016 with a vision of bringing creative solutions and efficiencies to today’s equity marketplace. The group’s key aims are to reduce trading costs and simplify market structure for the benefit of all market participants, and to act as a champion for end investors.

Central to this vision is Plato Partnership’s Market Innovator (MI3) that sponsors independent academic research and analysis that will identify better ways of executing trades, as well as lowering the cost and improving the quality of the broad range of processes required to support the execution lifecycle. Plato Partnership engage, and partner with, industry partners to achieve its goals and objectives and put its research findings into practice.

Members of Plato Partnership include:

Axa Investment Managers, Baillie Gifford, BlackRock, Cedar Rock, DWS Group, Fidelity International, Janus Henderson, Legal and General Investment Management, Liontrust, Norges Bank Investment Management, Union Investment, Barclays, Bank of America Merrill Lynch, Citi, Deutsche Bank, Goldman Sachs, Instinet, Jefferies, J.P. Morgan, Morgan Stanley, RBC, Redburn, Societe Generale and UBS.

For more information, please visit www.platopartnership.com.

<ESMA\_COMMENT\_CFE\_PA\_1>

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

<ESMA\_QUESTION\_CFE\_PA\_1>

YES.

<ESMA\_QUESTION\_CFE\_PA\_1>

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

<ESMA\_QUESTION\_CFE\_PA\_2>

YES. However frequent batch auctions remain a very small part of the overall Equity trading market.

<ESMA\_QUESTION\_CFE\_PA\_2>

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

<ESMA\_QUESTION\_CFE\_PA\_3>

Plato Partnership believes a reason for the growth in frequent batch auctions is these mechanisms allow for greater price protection while exhibiting low toxicity of liquidity and reducing speed advantages of some market participants that are prevalent on Lit Exchanges. We have witnessed a race for speed over the last 10 years in European equity trading that has provided a speed advantage to those that have a technology advantage and has caused concerns around toxicity of Lit Exchanges.

The research of academic Eric Budish, Professor of Economics at the University of Chicago, Booth School of Business(1) suggests that frequent batch auctions eliminate the mechanical arbitrages and the high frequency trading race, which in turn enhances liquidity and improves execution. Discrete time makes tiny speed advantages less valuable and the auction transforms competition on speed into competition on price. Consequently, frequent batch auctions eliminate the mechanical arbitrage, enhance liquidity for investors, and stop the high-frequency trading race.

Based on current evidence, frequent batch auctions result in very low-price reversion. In Lit and Dark trading, passive buy trades are followed by a strong drop in mid-point due to adverse selection by aggressive sellers. In contrast, frequent batch auction trades show almost no sign of adverse selection and therefore results in a very low-price reversion. This feature derives from random end time of auctions, which creates a level playing field for all market participants.

We also believe some of the growth in frequent batch auctions can be attributed to volumes that had previously been executed OTC prior to MiFID II as some EU Investment firms remain hesitant of the use of Systematic Internalisers.

Based on current evidence, we do not believe growth in frequent batch auctions is a direct result of the DVC, nor is the circumvention of the DVC the primary objective of frequent batch auctions. If this was the case, we would have expected to see the biggest move to periodic auctions happening in securities where dark trading below Large in Scale had been suspended under the DVC. In their research published 25/06/2018(2), the FCA analysed FTSE 350 shares using data from November 2017 to mid-April 2018 and noted that *“there is little difference in the growth in auction volume in shares where dark trading has been suspended under the DVC in comparison with shares for which dark trading is still allowed”*.

We advocate further research in this area using more recent data.

(1) The High-Frequency Trading Arms Race: Frequent Batch Auctions as a Market Design Response - Eric Budish, Peter Cramton, John Shim. The Quarterly Journal of Economics, Volume 130, Issue 4, 1 November 2015.

(2) https://www.fca.org.uk/publications/research/periodic-auctions.

<ESMA\_QUESTION\_CFE\_PA\_3>

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

<ESMA\_QUESTION\_CFE\_PA\_4>

YES. Plato Partnership view that the four key characteristics identified by ESMA - the application of pre-trade transparency, short auction duration, price determination within the best bid and offer price and self-matching features - should be the focus for assessment. However, there are significant differences across frequent batch auctions systems in how those characteristics are applied and we will note these differences in our subsequent responses and recommendations.

<ESMA\_QUESTION\_CFE\_PA\_4>

1. 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.

<ESMA\_QUESTION\_CFE\_PA\_5>

Plato Partnership believe that one of the key elements for a new venue or trading protocol is the performance of the mechanism and frequent batch auctions are no exception. A recent report by ITG, the largest global provider of Trade Cost Analysis,(3) supports the argument around improving results for the end investor suggesting that “frequent batch auctions have a similar cost profile to capped dark pools trading in block size, with execution across all benchmarks being close to zero”. They also suggested performance when trading in periodic auctions was superior to trading on Lit venues. Therefore, as a result of frequent batch auctions usage, the end investor benefits via price and liquidity measurements versus trading on Lit venues.

<ESMA\_QUESTION\_CFE\_PA\_5>

1. 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.

<ESMA\_QUESTION\_CFE\_PA\_6>

Plato Partnership believe there is inconsistency in regard to when different frequent batch auction systems apply pre-trade transparency. We view that all frequent batch auctions systems should disclose indicative price and quantity in market data once a match has occurred.

Disclosing indicative price and quantity on receipt of first order without a match will mean:

1. there is no auction price or size to publish if no bids have occurred so this information would serve little purpose and;
2. this has the potential to provide unnecessary information leakage for the first order and could cause unintended volatility in many traded shares across Europe.

In an academic research paper “Implementation Details for Frequent Batch Auctions: Slowing Down Markets to the Blink of an Eye”(4) the researchers suggest that disclosing only one side of an auction could result in gaming issues by some market participants if bids in a batch auction were displayed before the auction is conducted. The research view is this form of batch auction would be a bad outcome for fair and orderly trading.

(3) ITG “Venue Landscapes Shifts in Europe” 12 November 2018.

(4) Implementation Details for Frequent Batch Auctions: Slowing Down Markets to the Blink of an Eye - Eric Budish, Peter Cramton, and John Shim. American Economic Review: Papers & Proceedings 2014, 104(5): 418–424.

<ESMA\_QUESTION\_CFE\_PA\_6>

1. 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.

<ESMA\_QUESTION\_CFE\_PA\_7>

Please refer to our response in Q6.

<ESMA\_QUESTION\_CFE\_PA\_7>

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

<ESMA\_QUESTION\_CFE\_PA\_8>

NO. Order imbalance during the opening and closing auctions is appropriate as market participants are not able to use this advantage and trade ahead.

Frequent batch auctions take place throughout the trading day and market participants with the lowest latency would be able to leverage this information to their advantage and front run the auction itself which would not be the best interest of the broader market place. The publication of order imbalance information discourages asset managers from trying to trade large trades. Given that blocks typically reduce market impact, there would be a negative impact on European end investors if this was introduced.

<ESMA\_QUESTION\_CFE\_PA\_8>

1. 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.

<ESMA\_QUESTION\_CFE\_PA\_9>

All orders on frequent batch auction systems are placed on the auction order book with most orders resting for long periods until matching opportunities are identified. Execution allocations take place on a Price-Volume-Time basis and can therefore be considered as truly multilateral in nature and contributing to fair and orderly trading.

<ESMA\_QUESTION\_CFE\_PA\_9>

1. 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.

<ESMA\_QUESTION\_CFE\_PA\_10>

Plato Partnership believes the short auction durations (e.g. in some cases 50 - 100 milliseconds) are sufficient to enable sophisticated market participants (e.g. brokers with low latency technology) a reasonable opportunity to submit auction bids without causing significant information leakage. We believe it should be left to frequent batch operators and market participants to determine auction durations as these durations may need to be refined as market participants determine post trade performance of different auction models and make routing decisions to those that provide the best outcome for the end investor. We also believe it should be left to frequent batch operators and market participants to decide whether they wish to introduce defined periods beyond the minimum period (e.g. longer durations for less liquid instruments).

<ESMA\_QUESTION\_CFE\_PA\_10>

1. 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?

<ESMA\_QUESTION\_CFE\_PA\_11>

Plato Partnership defers to frequent batch system operators to provide this information to ESMA.

<ESMA\_QUESTION\_CFE\_PA\_11>

1. 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.

<ESMA\_QUESTION\_CFE\_PA\_12>

There appear to be two approaches to price formation depending on the frequent batch operator.

Two operators lock the auction price at the start of the call phase, using it for the auction uncross. This is designed to reduce the opportunity for price manipulation and offer price certainty to users.

In contrast, at least four other operators publish indicative prices that can change throughout the call period as participants add, remove, or amend orders. The indicative price is recalculated and published in real time with each order book event. When the auction ends, the price is formed using all orders submitted, following standard tie-breaker processes. This approach is most definitely price forming and is designed to maximise volume during the price formation process and is a common approach on all markets.

<ESMA\_QUESTION\_CFE\_PA\_12>

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

<ESMA\_QUESTION\_CFE\_PA\_13>

NO. Please see our response in Q12.

<ESMA\_QUESTION\_CFE\_PA\_13>

1. 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)?

<ESMA\_QUESTION\_CFE\_PA\_14>

All frequent batch auction systems enable orders to be placed on the auction order book with most orders resting for long periods until matching opportunities are identified with execution allocations taking place on a Price-Volume-Time basis and can therefore be considered as truly multilateral in nature and contributing to fair and orderly trading.

<ESMA\_QUESTION\_CFE\_PA\_14>

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

<ESMA\_QUESTION\_CFE\_PA\_15>

**NO. Pegged order types such as ‘At price’ mid-point pegs allow users to submit orders with prices that move in line with the Best Bid and Offer (BBO). The rationale for pegged orders is to allow users to track prices and manage their risk effectively. These order types are used across many trading mechanisms by both EU Investment Managers and Brokers and usually involve large program trades and have other trading characteristics attached to them. If an order is part of a larger program trade across multiple names, it allows the trader to manage, sector, country, regional and global risk. As the EU Investment Manager is happy to buy or sell the name at mid-point up to a certain basket threshold they would be considered in this case to be price forming.**

<ESMA\_QUESTION\_CFE\_PA\_15>

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

<ESMA\_QUESTION\_CFE\_PA\_16>

Plato Partnership defers to frequent batch system operators to provide this information to ESMA. However, there are times when Lit markets trade outside the EBBO and this emphasises the need for a comprehensive real-time European Equity Consolidated Tape.

<ESMA\_QUESTION\_CFE\_PA\_16>

1. 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?

<ESMA\_QUESTION\_CFE\_PA\_17>

Self-matching functionality, including member preferencing, has been available on most Exchanges and Lit and Dark MTFs for many years in European and International markets and such trades attract lower execution fees and lower (or zero) clearing/settlement costs for the benefit of EU Investment firms and end investors. Elimination of these functionalities would impose an unnecessary tax on investors and is contra to the objective of making markets more efficient.

In respect to Frequent Batch Auctions, Plato Partnership believes the perceived concerns of self-matching and member preferencing functionalities are overstated as (based on data from Turquoise) they form a small part of frequent batch auctions executed trades and result from liquidity that is truly addressable on a multilateral basis.

We outline this in more detail below using Turquoise data and suggest that ESMA seek to confirm the same holds true across other frequent batch auctions platforms.

Turquoise Lit Auctions self-matching trades represents approximately 17% of total executed trades in year to date October 2018 and means that market participants were able to eliminate or reduce trading and clearing fees for these executions. Whilst this may seem like a material percentage with respect to the broad accessibility of this liquidity, further analysis of these trades reveals that:

1. On average, the first order party to such self-match executions had rested in the market for ~200 seconds before the arrival of the second order and was therefore addressable liquidity and available for multilateral interaction throughout that period.

2. When looking only at the subset of self-matched executions where both orders arrived within a short duration (targeting the same ~100 milliseconds auction uncrossing window), these account for only 0.7% of the total number of executions.

3. Even where the 0.7% of self-matched orders were submitted within a short duration of one another, in 95% of these occasions there was an imbalance in the order sizes and hence that liquidity over and above the self-matched quantity would still have been addressable to other market participants despite the member-preferencing logic.

Plato Partnership therefore considers self-matching trades to be addressable liquidity and does not believe self-matching or member-preferencing to be an issue warranting regulatory intervention. The elimination of self-matching or member-preferencing would raise costs for market participants and end investors with no obvious justification or benefit to market integrity and run contra to the objective of making markets more efficient.

<ESMA\_QUESTION\_CFE\_PA\_17>

1. 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?

<ESMA\_QUESTION\_CFE\_PA\_18>

Please refer to our response in Q17. If member preferencing is been used to formalise privately negotiated transactions then this is been done in very limited circumstances given the Turquoise Lit Auctions data examples of non-addressable liquidity.

<ESMA\_QUESTION\_CFE\_PA\_18>

1. 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?

<ESMA\_QUESTION\_CFE\_PA\_19>

Given that member preferencing appears to be undertaken in very limited circumstances as outlined in our response in Q17, Plato Partnership does not consider member preferencing as indispensable for the success of frequent batch auctions**.**

However, Member preferencing across all venue-types reduces trading fees and clearing/settlement costs for market participants and end investors, and as such should not be removed without good reason. It helps to reduce price slippage for EU Investment firms and end investors due to low price reversion that derives from random end time of auctions, which creates a level playing field for all market participants.

It also assists brokers in delivering best execution to EU Investment firms in a manner that, consistent with market transparency and regulation, eliminates unnecessary intermediation of institutional order flow by high-frequency and proprietary trading firms.

Therefore Plato Partnership would defend member-preferencing in principle, especially as no evidence has been presented suggesting detriment to market integrity.

<ESMA\_QUESTION\_CFE\_PA\_19>

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

<ESMA\_QUESTION\_CFE\_PA\_20>

Plato Partnership defers to individual EU Investment Managers and Brokers that submit responses.

<ESMA\_QUESTION\_CFE\_PA\_20>

1. 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.

<ESMA\_QUESTION\_CFE\_PA\_21>

Plato Partnership does not have this information.

<ESMA\_QUESTION\_CFE\_PA\_21>

1. 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?

<ESMA\_QUESTION\_CFE\_PA\_22>

Plato Partnership expects that significant changes to frequent batch auctions will result in a volume shift to Systematic Internalisers rather than to Lit Exchanges given the potential market impact benefits. The reasons for this were outlined in our response to Q3 in that Lit Exchanges exhibit higher toxicity of liquidity as they provide speed advantages to some market participants and these aspects are not prevalent on Systematic Internalisers**.**

<ESMA\_QUESTION\_CFE\_PA\_22>