

## OPINION

### On frequent batch auctions (FBAs) and the double volume cap mechanism (DVCM)

#### 1 Legal basis

1. ESMA's competence to deliver an opinion to competent authorities (CAs) is based on Article 29(1)(a) of Regulation (EC) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority)<sup>1</sup> (ESMA Regulation).
2. Pursuant to Article 29(1)(a) of the ESMA Regulation, ESMA shall provide opinions to CAs for the purpose of building a common Union supervisory culture and consistent supervisory practices, as well as ensuring uniform procedures and consistent approaches throughout the Union.

#### 2 Background

3. Article 3 of Regulation (EU) No 600/2014<sup>2</sup> (MiFIR) sets out pre-trade transparency requirements for equity instruments in order to inform market participants of trading opportunities and prices and to ensure that the price discovery process is not impaired by the fragmentation of liquidity.
4. MiFIR recognises that there may be circumstances where exemptions from the pre-trade transparency obligations should be provided to avoid the impairment of liquidity as an unintended consequence of obligations to disclose orders and thereby to make public positions at risk. Article 4 of MiFIR, as further specified in Commission Delegated Regulation (EU) 2017/587 (RTS 1)<sup>3</sup>, sets out the different types of pre-trade transparency waivers.
5. In order to ensure that the use of pre-trade transparency waivers does not harm price formation, Article 5 of MiFIR introduces the double volume cap mechanism (DVCM). Orders placed in systems which are based on a trading methodology by which the

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<sup>1</sup> OJ L 331, 15.12.2010, p. 84

<sup>2</sup> Regulation (EU) No 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Regulation (EU) No 648/2012 (OJ L 173, 12.6.2014, p. 84).

<sup>3</sup> Commission Delegated Regulation (EU) 2017/587 of 14 July 2016 supplementing Regulation (EU) No 600/2014 of the European Parliament and of the Council on markets in financial instruments with regard to regulatory technical standards on transparency requirements for trading venues and investment firms in respect of shares, depositary receipts, exchange-traded funds, certificates and other similar financial instruments and on transaction execution obligations in respect of certain shares on a trading venue or by a systematic internaliser (OJ L87, 31.3.2017, p. 387).

price is determined in accordance with an external reference price (Article 4(1)(a) of MiFIR, reference price waiver, RPW) and negotiated transactions in liquid instruments (Article 4(1)(b)(i) of MiFIR, NTW) are subject to the DVCM.

6. The DVCM limits the use of the RPW and the NTW in a financial instrument on a particular trading venue to 4% of the total trading volume in the EU over the previous 12 months. Where a trading venue breaches this threshold, the CA should suspend the use of the waivers on that particular trading venue for a period of 6 months.
7. Moreover, where the total trading volume in a financial instrument under the RPW and the NTW on all trading venues across the EU is above 8% of the total volume of trading on all EU trading venues over the previous 12 months, CAs should suspend the use of the two waivers on all trading venues across the EU.
8. Following the application of MiFID II/MiFIR, the DVCM, starting in March 2018, triggered the suspension of more than 1,600 financial instruments resulting in the RPW and the NTW no longer being available, either on a particular trading venue in case the 4% threshold was breached, or across all EU trading venues where the trading volume exceeded 8%.
9. FBA systems for equity instruments are a new type of periodic auction trading system, which started gaining market share in 2018, in particular following the first suspension of trading under the DVCM. Most FBA systems do not operate under a waiver from pre-trade transparency and apply the pre-trade transparency requirements for 'periodic auction trading systems'.
10. In order to ensure consistent application of the relevant requirements by FBA systems across the Union and to avoid that FBA systems are used to circumvent the application of the DVCM, ESMA considers it necessary to provide further clarification regarding the application of the pre-trade transparency requirements by FBA systems and the price determination process of FBA systems.
11. ESMA has considered that such clarification will contribute positively to the consistency of supervisory practices and will ensure consistent approaches throughout the Union, as a result of which, ESMA has decided to issue this Opinion.

### **3 Opinion**

12. ESMA is supportive of initiatives developing new trading protocols and providing technological innovations with the aim of increasing the quality of execution and ultimately benefiting end investors. FBA systems appear to be a response to the new requirements of MiFID II/MiFIR and have gained traction and acceptance by investors.
13. Nevertheless, ESMA considers that new trading protocols and innovations should be developed in line with the requirements and objectives of MiFID II/MiFIR. In particular, MiFID II aims at making financial markets in the EU more transparent and ensuring

that sufficient trading is executed on venues that are subject to pre- and post-trade transparency requirements and contribute to the price formation process.

14. Periodic auction trading systems are described in Table 1 of Annex I of RTS 1 as “*a system that matches orders on the basis of a periodic auction and a trading algorithm operated without human intervention*”. This description reflects the description of periodic auction trading systems as included in MiFID I<sup>4</sup>.
15. The general purpose of auctions is to contribute to the price formation process. In conventional auction systems orders are aggregated before and during the auction call without leading to a trade and at a specified point in time buy and sell orders are matched and executed at a single equilibrium price. The description of periodic auctions contained in RTS 1 aims at capturing these characteristics.
16. The description aimed, in particular, at capturing conventional periodic auctions, i.e. opening and closing auctions, and did not take into account FBA systems which did not exist at the time. FBA systems are auction systems of a very short duration taking place at certain points in time during the course of the trading day and are triggered by market participants. Orders are aggregated before and during the auction call without leading to a trade and at a specific point in time matched and executed at a single price. In ESMA’s view, FBA systems therefore share the characteristics of periodic auctions as described in RTS 1.

### 3.1 Application of pre-trade transparency by FBA systems

17. FBA, being captured by the description of periodic auctions, apply the pre-trade transparency requirements applicable to periodic auctions trading systems as specified in Annex 1 of RTS 1. Periodic auction trading systems are required to publish ‘*the price at which the auction trading system would best satisfy its trading algorithm in respect of shares, depositary receipts, ETFs, certificates and other similar financial instruments traded on the trading system and the volume that would potentially be executable at that price by participants in that system*’.
18. The MiFIR pre-trade transparency provisions aim at informing investors of the true level of potential transactions, thereby ensuring that the price discovery process is not impaired by the fragmentation of liquidity across different trading venues. ESMA considers it important that all trading venues publish pre-trade transparency information to deliver on this objective, unless they benefit from a waiver from pre-trade transparency.
19. ESMA notes that the pre-trade transparency requirements for periodic auctions specified in Annex I of RTS 1 do not bring sufficient clarity in respect of FBA systems

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<sup>4</sup> Table 1 of Annex II of Commission Regulation (EC) No 1287/2006.

where an auction call is initiated upon the receipt of the first order but pending a potential match.

20. In consequence, currently most FBA systems initiating an auction call upon the receipt of the first order do not publish any pre-trade transparency information pending a potential match. This results in a situation where investors are not sufficiently informed of the true level of potential trading opportunities.
21. ESMA considers it necessary to provide clarification on how to apply the pre-trade transparency requirements in such situations. For the purposes of such clarification, ESMA is guided by the objectives of MiFID II/MiFIR mentioned in paragraph 13 above and takes into account the requirements set out in Articles 18(1) and 47(1)(d) of MiFID II for trading venues to establish transparent rules and procedures for fair and orderly trading.
22. In view of the above, ESMA considers that trading venues operating FBA systems initiating auction calls on the basis of the first incoming order pending a potential match should inform market participants that an auction has started, thereby making market participants aware that there might be a trading opportunity and enabling them to participate in the auction.
23. ESMA expects that, as soon as a potential match has been identified, the pre-trade transparency requirements as specified in Annex I of RTS 1 should apply, i.e. the trading venue should make public the indicative price and volume.

### 3.2 The price determination process of FBA systems

24. As described above, the main objective of auctions in general, including periodic (such as opening and closing auctions and FBA systems) and continuous auctions, is to contribute to the price formation process.
25. MiFIR recognises that under clearly specified circumstances certain orders/transactions may not need to be made pre-trade transparent and introduces waivers from pre-trade transparency. One reason for this is that some of these orders/transactions, in particular orders based on a reference price trading methodology and negotiated transactions in liquid instruments, do not contribute to the price formation process.
26. Pre-trade transparency waivers for equity instruments are, in principle, available for any type of trading systems. Therefore, periodic auction systems, including FBA systems, could operate as non-price forming systems and benefit from a pre-trade transparency waiver, in particular the RPW and the NTW. In this case, FBA systems would also become subject to the DVCM. ESMA considers that non-price forming FBA systems should, in principle, operate under a waiver from pre-trade transparency.

27. FBA systems currently rely on three practices namely the use of pegged orders, price band limitations (with the objective of ensuring the price is always within the European Best Bid an Offer (EBBO)/ Primary Best Bid and Offer (PBBO)) and locking in prices at the beginning of the auction. ESMA is of the view that these practices may undermine the price formation process and, in that way, diverge from the main objective of an auction.
28. ESMA considers that the following functionalities would result in non-price forming FBA systems:
- Systems that allow only for the submission of pegged orders and/or 'adjusted limit orders', i.e. orders that reference to a price from other systems and/or limit orders that are automatically adjusted to be within the limits of the BBO aiming at ensuring that all transactions will be either executed at mid-point and, in any case, within the BBO at the time of submitting the order. ESMA considers that such systems may be eligible for a waiver from pre-trade transparency.
  - The use of price band limitations referring to prices determined by other systems ensuring that the uncrossing price is always within the EBBO/PBBO.
  - Systems that lock in the prices at the beginning of an auction, where the locked in price does not follow the submission of unadjusted limit orders.
29. Regarding the second functionality described above, ESMA is of the view that FBA systems using price band limitations referring to the EBBO or PBBO do not meet the MiFIR conditions for granting an RPW.
30. Firstly, according to Article 4(1) of MiFIR, the reference price should be derived from a single trading venue whereas the current price band limitations of FBA systems rely on reference prices from various trading venues to determine the EBBO/PBBO. Secondly, according to Article 4(2) of MiFIR the reference price should be either the mid-point or the opening or closing price where the mid-point is not available. A price collar referring to the EBBO/PBBO does not meet the conditions in Article 4(2) of MiFIR.
31. Regarding the third functionality described above, ESMA considers that systems that lock in the price at the beginning of an auction where the price is determined based on unadjusted limit orders are price-forming systems. ESMA considers that systems that lock in prices based on other conditions are non-price forming and should, in principle, operate under a waiver from pre-trade transparency.
32. ESMA will keep monitoring the developments in the market, including how trading venues adapt their systems to meet the guidance on the operation of FBA systems set out on this Opinion. Should it prove necessary, ESMA will issue further guidance in order to ensure the convergent application of the MiFID II / MiFIR requirements across the EU, in particular with respect to transparency and price formation.