



# The Xetra intraday auction: Growing potential for strong price discovery

by Miroslav Budimir, Senior Vice President, Deutsche Börse AG

Several weeks ago the London Stock Exchange (LSE) announced the introduction of an intraday auction in late 2015. This way the LSE intends to meet the demands of market participants from the buy-side, and to answer the challenges which will arise as consequence of the Dark Pool Waiver Caps.

To be introduced in 2017 as part of MiFID II, the caps on dark pool trading for both the Reference Price Waiver and the Negotiated Trade Waiver will limit the opportunities for the buy-side to execute their small orders in the darkness and thereby adversely affect the expected outcome of a trade. One solution to this dilemma might be to increase the size of child orders beyond the large-in-scale

thresholds and to migrate them to block trading venues. Another – and probably better – solution would be trading these orders in the deep liquidity pools of the home market, especially in auctions.

Traditionally, the intraday auction has been standard procedure on Xetra® for the last 15 years. It is an ideal facility to trade large sizes at fair and reliable prices, formed by a multitude of market participants interacting with each other in the process of price formation. The Xetra intraday auction takes place at 1pm CET each trading day and serves the same purpose as the opening and closing auctions on Xetra. In contrast to continuous trading, auctions batch liquidity and calm down

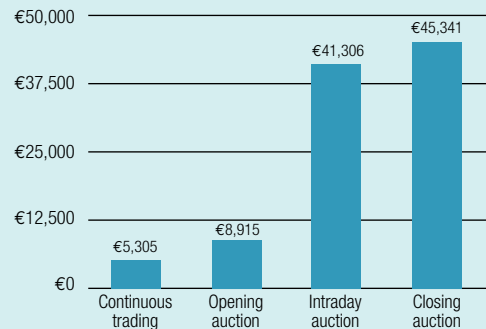
the market. They contribute significantly to price discovery: Prices determined in an auction have proven very reliable since they are a result of strong demand and supply conditions. A recent study\* by the University of Frankfurt has shown that, especially during an intraday auction, Xetra is the price leading venue for German shares. A major finding was that the indicative Xetra auction prices were more informative than actual trade prices on competing platforms

In an auction, large trades can be executed. In Q3 2014, the average trade size in the Xetra Intraday Auction was almost eight times higher than in continuous trading (see Figure 1). These are precisely those execution opportunities that the buy-side is currently looking for.

Trading in auctions is naturally slower than continuous trading. A Xetra Intraday Auction is initiated by a two-minute call period (or at least five minutes on Eurex Settlement days), followed by a “random end” phase which can last up to 30 seconds. This phase is required in order to prevent gaming of the auction price. Eventually, this intentional slowdown of trading leads to a situation that some investors might highly appreciate: the liquidity batched during an auction is usually not provided by speed-savvy players, who prefer the low-latency environment of the continuous trading phase during the rest of the trading day. This fact might be perceived as highly attractive for the buy-side.

As of today, Deutsche Börse’s auction concept has already proven very successful. On Xetra, some 28% of the overall daily trading volume are executed during auctions. The vast majority of this figure stems from the closing auction, whereas the intraday auction still has significant growth potential. Currently, around two per cent of total daily volumes in DAX shares are traded via the intraday auction. Since the intraday auction offers institutional investors an opportunity to execute large blocks at fair and reliable prices, this is also a solution to the problem many market participants will have when the 4% cap for dark trading in an instrument per venue respectively the 8% cap overall will come into effect. With this in mind,

**Figure 1: Xetra DAX trade size per trading form (Q3 2014)**



Deutsche Börse expects a strong growth for its Intraday Auction. With other markets picking up this trading form more and more market participants will almost certainly adapt the idea of intraday auctions and start participating, eventually creating a virtuous circle of liquidity.

Another important factor that will influence how fast and to what degree the intraday auction model will be adapted by market participants would be the trading fees. In contrast to some other trading venues, Deutsche Börse does not make a distinction between continuous trading and auctions on Xetra when it comes to transaction fees. Thus, auction trading costs far less than half a basis point on Xetra.

The restrictions expected with MiFID II coming into force should pull trading volume from dark pools to regulated and transparent trading venues like Xetra. The current change has the potential to shift more trading to the lit venues, which will eventually further strengthen the existing transparent liquidity pools and thereby their price discovery function – a feat that is of paramount relevance for both investors and the general public. ■

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*\*Benjamin Clapham: "Price Discovery in Fragmented Markets – An Event Study Based on Trading Data from Deutsche Börse and BATS Chi-X Europe." Johann Wolfgang Goethe University Frankfurt, 2014.*

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