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| Response Form to the Call for evidence on pre-hedging |
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**Responding to this paper**

ESMA invites comments on all matters in this consultation paper and in particular on the specific questions. Comments 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.

ESMA will consider all comments received by **30 September 2022.**

**Instructions**

In order to facilitate analysis of responses to the Consultation Paper, respondents are requested to follow the below steps when preparing and submitting their response:

1. Insert your responses to the questions in the Consultation Paper in the present response form.
2. Use this form and send your responses in Word format (**pdf documents will not be considered except for annexes**);
3. Please do not remove tags of the type <ESMA\_QUESTION \_PHDG\_1>. Your response to each question has to be framed by the two tags corresponding to the question.
4. If you do not wish to respond to a given question, please do not delete it but simply leave the text “TYPE YOUR TEXT HERE” between the tags.
5. When you have drafted your response, name your response form according to the following convention: ESMA\_PHDG\_nameofrespondent\_RESPONSEFORM. For example, for a respondent named ABCD, the response form would be entitled ESMA\_PHDG\_ABCD\_RESPONSEFORM.
6. Upload the form containing your responses, **in Word format**, to ESMA’s website (www.esma.europa.eu under the heading “Your input – Open Consultations” -> Consultation Paper on the clearing and derivative trading obligations in view of the benchmark transition”).

**Publication of responses**

All contributions received will be published following the close of the consultation, unless you request otherwise. Please clearly and prominently indicate in your submission any part you do not wish to be publically disclosed. A standard confidentiality statement in an email message will not be treated as a request for non-disclosure. 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 not to disclose the response 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 heading [Legal Notice](http://www.esma.europa.eu/legal-notice).

**Who should read this paper**

All interested stakeholders are invited to respond to this call for evidence. This call for evidence is primarily of interest to investment firms, credit institutions, proprietary traders, market makers, asset management companies and in general persons operating on an ongoing basis in financial markets, but responses are also sought from any other market participants including trade associations and industry bodies, institutional and retail investors, consultants and academics.

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**General information about respondent**

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| Name of the company / organisation | European Fund and Asset Management Association (EFAMA) |
| Activity | Investment Services |
| Are you representing an association? |  |
| Country/Region | Belgium |

**Questions**

1. Do you agree with the proposed definition of pre-hedging with respect to case (i) and (ii)? Please explain elaborating if both case (i) and case (ii) in your view can qualify as pre-hedging and providing specific examples on both instances.

<ESMA\_QUESTION\_PHDG\_1>

Introduction

EFAMA appreciates the opportunity to comment on ESMA’s Call for Evidence on pre-hedging. This is an area where we have previously expressed views on in the ESMA 2019 MAR consultation. We agree that a Call for Evidence is appropriate, and that a more in-depth examination of current market practices is useful. EFAMA also believes that any resulting regulation should not have a negative impact on prices or hinder the availability of liquidity, but should aim to curb any pre-hedging activity that harms the client or disrupts the market.

EFAMA would like to share the following general comments:

* **No illegitimate pre-hedging**: We are opposed to any pre-hedging activity for illegitimate purposes such as front running, or where there would be no clear benefit from such transactions to the client trade, or indeed if as a result of pre-hedging there is an inadvertent price movement where the liquidity provider has not sought to minimize market impact.
* **Transparency**: Under defined circumstances pre-hedging should be possible, but transparency toward the client is of paramount importance. Brokers should be open and honest when they are pre-positioning themselves in anticipation of an order, post receipt of an RFQ. The transparency obligation should provide the client with execution choice.
* **Market Characteristics:** Due to the different functioning of markets in different asset classes ESMA should carefully consider those differences and be wary of a “one-size fits” all approach when producing guidance
  + Legitimate pre-hedging driven by brokers trying to deliver best execution should be allowed, however the liquidity of the market should be taken into account. Pre-hedging in an illiquid market may be justified, but less so in a very liquid market. However, this should not lead to a binary liquid/illiquid approach. The over-riding consideration should be the necessity to pre-hedge and client benefit, with liquidity being a factor in that consideration without introducing a prescriptive test.
* For orders submitted via an RFQ platform, these cannot all be treated as inside information. We would argue that a two-way quote is unlikely to provide information that can be ‘front-run’, but one-way quotes with size may be deemed inside information to the extent that the client is a large shareholder in a given name, and may indicate to the market that there is some significant unwind activity. We can also think of scenarios where a two-way quote could be considered precise information, i.e if there is adverse news on a listed security subject to an RFQ, and a fund has a disclosed long position, a broker may be able to deduce the direction and size of the trade.
* Global FX Code (“GFXC”) rules could be a useful starting point for key principles that would be compatible with underlying markets.
* Liquidity Providers should only be allowed to pre-hedge when acting as Principal. In cases where a market participant is acting solely as agent, pre-hedging should be not be allowed.
* Liquidity providers should be able to demonstrate the legitimate purpose of their pre-hedging activity.

Reply to question 1

Yes, considering the underlying principle, we think that front running should be disallowed in whatever form and that SIs, in other words our providers, should adopt ( if not already done as per regulations ) an internal code of conduct to ban those practices and ensure that they have a framework in place to ensure that any pre-hedging is undertaken in a way that does not disadvantage clients and/or adversely impact the market. Such a framework should include a policy setting out the permitted parameters of pre-hedging, including how a provider cannot gain any material advantage either (i.e cannot trade on own account or against a client unless they already have an open order before receipt of the RFQ).<ESMA\_QUESTION\_PHDG\_1>

1. Do you believe the definition should encompass other market practices? Please explain.

<ESMA\_QUESTION\_PHDG\_2>

No we cannot think of other market practices which should be encompassed by the definition.

<ESMA\_QUESTION\_PHDG\_2>

1. Do you agree with the proposed distinction between pre-hedging and hedging?

<ESMA\_QUESTION\_PHDG\_3>

Yes, hedging occurs post winning the trade whereas pre-hedging occurs when bidding for the trade by the SI and therefore before the execution of the underlying transaction that is being hedged..

<ESMA\_QUESTION\_PHDG\_3>

1. Do you have any specific concerns with respect to the practice of pre hedging being undertaken by liquidity providers when the trading protocol allows for a ‘last look’?

<ESMA\_QUESTION\_PHDG\_4>

It is worth noting that we do not typically observe such practice for other markets. A “last look” as described by ESMA in items 14 and 15 is a widely-spread practice in the FX market and can be legitimate:

* when it is not possible for the liquidity provider to perform credit checks before trading (for example if a trading platform doesn’t allow pre-allocation or for voice trading in which case pre-allocation is impractical)
* when there is an unusual communication delay between the trading platform and the parties to the transaction which means the quote is not valid anymore

This being said one could think that there is some degree of abuse by some market participants as rejection due to market moves during the “last look” window is unfortunately rarely symmetrical (almost always benefit and at the discretion of the market maker).<ESMA\_QUESTION\_PHDG\_4>

1. What is your view on the arguments presented in favour and against pre-hedging?

<ESMA\_QUESTION\_PHDG\_5>

Difficult to answer as of course information from the RFQ process could be used to draw conclusions in regards to effect on prices but at the same time not all price movements against client transactions can be explained by abusive pre-hedging activity from liquidity providers included in an RFQ.

That said, we agree with the argument that competitive RFQs can lead to detrimental price impact for clients if multiple RFQ participants pre-hedge without certainty of winning the trade, eg for RFQs for an ETF. There is very limited reason for this practice to be acceptable

Furthermore, we agree with the argument that pre-hedging can result in lower bid-offer spreads for clients. This can be beneficial and can make pre-hedging legitimate. As a general principle we believe it is important to focus on the benefit for the client – a lower bid-offer spread would not be beneficial if it is offset by larger price slippage – **so focus on client benefit is the more important principle**<ESMA\_QUESTION\_PHDG\_5>

1. In which cases could a foreseeable transaction enable a conclusion to be drawn on its effect on the prices?

<ESMA\_QUESTION\_PHDG\_6>

We agree that one-way quotes have an element of preciseness, in particular where there is a reasonably expectation that the underlying transaction will go ahead. Although it may be less apparent for two-way quotes, the direction on the possible impact on the price should be irrelevant in determining whether information is precise. Per Article 7 (2) of MAR, information shall be deemed to be of a precise nature if it indicates a set of circumstances which exists or which may reasonably be expected to come into existence, or an event which has occurred or which may be reasonable expected to occur, where it is specific enough to enable a conclusion to be drawn as to the possible effect of that set of circumstances or event on the process of the financial instruments or the related derivative financial instrument, the related spot commodity contracts, or the auctioned products based on the emission allowance.

<ESMA\_QUESTION\_PHDG\_6>

1. Do you agree that an RFM when the liquidity provider could discover the trading intentions of the sender on the basis of their past commercial relationship, the market conditions or the news flow should be considered as precise information?

<ESMA\_QUESTION\_PHDG\_7>

Yes

<ESMA\_QUESTION\_PHDG\_7>

1. Please provide your views regarding the criteria for the identification of RFQs that could potentially have a significant impact on the price of the relevant financial instrument. Is there any other criterion that ESMA should take into account?

<ESMA\_QUESTION\_PHDG\_8>

We believe that size of the trade versus available market liquidity and overall risk of the trade should be taken into account and recognise that this should be on a case-by-case basis

If a RFQ is based on a potentially sizeable transaction vs the underlying liquidity or if the overall risk transfer of the trade is large, then its execution may have a market moving effect and thus this information is confidential.<ESMA\_QUESTION\_PHDG\_8>

1. Does the GFXC Guidance describe all the possible cases of risk management rationale that could justify legitimate pre-hedging? If not, please elaborate

<ESMA\_QUESTION\_PHDG\_9>

The GFXC Guidance is a valid basis for considerations. There are some general principles which should be respected no matter the underlying asset class (such as only principal trading benefitting from pre-hedging possibility or transparency and control requirements). This being said due to the different functioning of markets a“no one-size fits all approach”, should be adopted and an in-depth analysis of different practices and functioning of RFQ process should be undertaken.

<ESMA\_QUESTION\_PHDG\_9>

1. Can you identify practical examples of pre-hedging practices with/without a risk management rationale?

<ESMA\_QUESTION\_PHDG\_10>

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<ESMA\_QUESTION\_PHDG\_10>

1. Can pre-hedging be considered legitimate when the market participant is aware, on the basis of objective circumstances, that it will not be awarded the transaction?

<ESMA\_QUESTION\_PHDG\_11>

No, in that instance pre hedging may be considered to be front running. GFXC Principle 11 and FMSB Standards may be helpful starting points here, where the former refers to a “reasonable expectation” of the transaction going ahead and the latter to “legitimate expectations” to take on market risk.

Therefore we agree that where a liquidity provider **cannot reasonably assume** that they will win an RFQ they should not be allowed to pre-hedge<ESMA\_QUESTION\_PHDG\_11>

1. Can you identify financial instruments that should/should not be used for pre-hedging purposes? Please elaborate

<ESMA\_QUESTION\_PHDG\_12>

We can agree on pre- hedging for legitimate purposes , subject to some degree of control that can be exercised by and evidence delivered to the client. This should involve a demonstration that steps have been taken to manage any conflicts of interest and impact on the price of the relevant instrument are appropriately considered. If those conditions are fulfilled, we see no rationale to limit instruments being used.

<ESMA\_QUESTION\_PHDG\_12>

1. Please provide your views on the proposed indicators of legitimate and illegitimate pre-hedging. Would you suggest any other?

<ESMA\_QUESTION\_PHDG\_13>

Generally, we agree with the proposed indicators of legitimate behavior and that pre-hedging should only be used for risk management purposes with the Liquidity Provider acting as Principal, where there is a likelihood of the underlying transaction going ahead and when it is in the interests of the client to do so.

While liquidity can be a relevant factor for whether pre-hedging is legitimate, we would recommend against a binary liquid/illiquid approach. The principle to demonstrate that pre-hedging is necessary and in the client interest seems more appropriate. Liquidity may be one way for the liquidity provider to demonstrate client benefit but this does not need to be in regulation as a binary and prescriptive indicator<ESMA\_QUESTION\_PHDG\_13>

1. According to your experience, can express consent to pre-hedging be provided on a case-by-case basis in the context of electronic and competitive RFQs? If yes, how? Do you think the client’s consent to pre-hedging should ground a presumption of legitimacy of the liquidity provider’s behaviour?

<ESMA\_QUESTION\_PHDG\_14>

As per Q12, under such circumstances, we would not go electronic and we would adapt our RFQ process to the specificity of the trade being contemplated to preserve confidentiality and  leave some room for our counterparty to recycle the risk; Alternatively, disclosure to clients (i.e in Terms of Business) by the liquidity provider that it may undertake pre-hedging activity could be appropriate.

<ESMA\_QUESTION\_PHDG\_14>

1. Could you please indicate which are in your view the pre-hedging practices that appear to be conducted mostly in the interest of the liquidity provider and which may risk to not bring any benefit to the client?

<ESMA\_QUESTION\_PHDG\_15>

Generally, we do not see any room for pre-hedging practices where the benefit to the client transaction could not be demonstrated.

For example, when the buyside asks for a risk price on a program trade, they will give up some information such as ‘FTSE250 basket $100mln, 200 names’. If you ask a number of brokers for a price and expose direction, there is a possibility that some brokers may pre hedge their risk to you by trading futures.

<ESMA\_QUESTION\_PHDG\_15>

1. Do you think it would be feasible for liquidity providers to provide evidence of (i) their reasonable expectation to conclude the transaction; (i) the risk management needs behind the transactions; (iii) the benefit for the client pursued through the transaction and (iv) the client’s consent? If no, please indicate potential obstacles to the provision of such evidence.

<ESMA\_QUESTION\_PHDG\_16>

Liquidity providers should make sure that their employees respect an internal code of conduct, and be in a position to provide evidence to their clients. Such obligations should be systematically integrated in trading agreements and could be provided through formal due diligence processes or attestation arrangements where permissible.

<ESMA\_QUESTION\_PHDG\_16>

1. Do you believe that the liquidity of a financial instrument should be considered as an indicator in determining whether pre-hedging may be illegitimate behaviour? Please elaborate.

<ESMA\_QUESTION\_PHDG\_17>

Yes, as indicated in our answer to Q8 and Q13.

<ESMA\_QUESTION\_PHDG\_17>

1. According to your experience does the practice of pre-hedging primarily take place in what is described as the ‘wholesale markets’ space or does this practice take place also with respect to order / RFQs submitted by retail or professional clients?

<ESMA\_QUESTION\_PHDG\_18>

EFAMA members submit RFQs as professional clients and cannot comment on retail space. We refer to our answer to Q 12.

<ESMA\_QUESTION\_PHDG\_18>

1. As an investment firm conducting pre-hedging, do you have any internal procedure addressing the COI which might arise specifically from such practice? If yes, please briefly explain the content of such procedure.

<ESMA\_QUESTION\_PHDG\_19>

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<ESMA\_QUESTION\_PHDG\_19>

1. According to current market practice, do investment firms disclose to clients that their RFQs might be pre-hedged? If so, does this happen on a case-by-case basis (i.e. a client is informed that a specific order might be pre-hedged) or is this rather a general disclosure? Please elaborate, distinguishing between various trading models, e.g. voice trading vs electronic trades and please specify if there are instances in which RFQ systems allow to specify is pre-hedging is conducted?

<ESMA\_QUESTION\_PHDG\_20>

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<ESMA\_QUESTION\_PHDG\_20>

1. According to current market practice, are clients offered quotes with and without pre-hedging, leaving to the client a choice depending on his execution preferences? Is so in which instances?

<ESMA\_QUESTION\_PHDG\_21>

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<ESMA\_QUESTION\_PHDG\_21>

1. Do you currently keep record of pre-hedging trades and related trading activity? Do you believe record keeping in this instance would be easy to implement?

<ESMA\_QUESTION\_PHDG\_22>

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<ESMA\_QUESTION\_PHDG\_22>

1. Would you like to highlight any specific issue related to the obligation to provide clear and not misleading information?

<ESMA\_QUESTION\_PHDG\_23>

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<ESMA\_QUESTION\_PHDG\_23>

1. Should ESMA consider any other element with respect to pre-hedging and systematic internalisers and OTFs? Please elaborate

<ESMA\_QUESTION\_PHDG\_24>

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