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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 | MarketAxess NL B.V. |
| Activity | Regulated markets/Exchanges/Trading Systems |
| Are you representing an association? |  |
| Country/Region | Netherlands |

**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>

For case (i) we would consider pre-hedging to incorporate any scenario whereby two counterparties interact with each other to discuss a potential trade which may or may not include an RFQ. This would include those situations where a client discusses the possibility of arranging a trade with a dealer but has not yet launched an RFQ. Such a situation may give rise to the dealer to undertake pre-hedging whether for legitimate or illegitimate purposes. We would not consider case (ii) to qualify as pre-hedging given that the risks of the hedge is known, rather than being unknown.

<ESMA\_QUESTION\_PHDG\_1>

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

<ESMA\_QUESTION\_PHDG\_2>

Please refer to our response in Question 1 in relation to case 1

<ESMA\_QUESTION\_PHDG\_2>

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

<ESMA\_QUESTION\_PHDG\_3>

We consider that hedging (as opposed to pre-hedging) may be undertaken before the order has been confirmed by the client or a foreseeable transaction has been executed. This is due to the fact that there is a firm commitment to execute the trade between the client and dealer and the risk of the hedge is known. Hedging, therefore, should incorporate trading activity relating to (i) dealing on own account, and (ii) to mitigate an inventory risk which is foreseen due to a possible incoming transaction with a client.

<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>

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<ESMA\_QUESTION\_PHDG\_4>

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

<ESMA\_QUESTION\_PHDG\_5>

Clearly there are thoughtful arguments for and against pre-hedging. This suggests that there is no binary answer to determine if pre-hedging is inappropriate even if it is conducted for legitimate purposes. Generally speaking, we would consider that dealers should incorporate appropriate policies, monitoring and controls to prevent any abusive practices associated with pre-hedging. This will mitigate the arguments against pre-hedging. Conversely, this will promote the arguments for pre-hedging which we consider to ultimately benefit the client (e.g. better quality and certainty of execution and supporting liquidity in illiquid products)

<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 do not agree with the conclusion in paragraph 4.1.9 that RFQs can be considered as non-public information altogether for the reasons set forth below.

1. Whilst RFQs may meet the relevant characteristics of non-public information as described in paragraphs 4.1.6-4.1.8, ‘all-to-all’ RFQ protocols such as the Open Trading protocol offered by MarketAxess’s MTF enables an unlimited number potential liquidity providers to respond to an RFQ. In such case it is not non public.

In terms of market coverage, this is no different to those market participants having access to a central limit order book (‘CLOB’), where they can see actionable trading interests of a large number other market participants (bids/offers). CLOBs are not considered in the CfE as a source of non-public information, and all-to-all RFQ (or an RFQ to many) ought to be considered in the same way. The question of what constitutes “many” and when “many” is no longer non public depends on other characteristics of the instrument and the inquiry, case by case and there is unlikely to be a hard and fast rule that can be applied abset the characteristics of the market and the inquiry in question. See further answer to Q8

1. Article 7 of MAR does not specifically contemplate RFQs as being a type of protocol falling with the concept of inside information rather, client orders (see Article 7.1(d) MAR). Any consideration of RFQ to be considered as ‘inside information’ could have detrimental outcomes for price discovery in illiquid markets (such as bonds) and (price discovery via RFQ) is essential for the provision of liquidity in such markets.

<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>

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<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>

The size of an RFQ could have a significant impact on the price on the instrument but there are also other factors namely the characteristics of the instrument such as liquidity, material news, and the type of the instrument itself. Creating parameters would be a challenging if not impossible task to prescribe criteria noting that instruments are constantly updated on a daily basis and would require significant resources to assess and support the policy approach. Such action may be disproportionate to the risk that is trying to be managed,

<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>

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<ESMA\_QUESTION\_PHDG\_9>

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

<ESMA\_QUESTION\_PHDG\_10>

No, we cannot, nor is it clear if there is any justification to pre-hedge without a risk management rationale. Our expectation is that clients and dealers have appropriate controls to ensure that pre-hedging is appropriate and justifiable in whichever circumstances it is undertaken.

<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>

We do not consider that pre-hedging will be considered to be legitimate in the manner contemplated in this question. This type of behaviour is potentially unhedged risk taking and a counter intuitive practice.

<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>

None that we would consider that should or should not be used for pre-hedging. The practice of pre-hedging should not be limited to one instrument or another if undertaken for legitimate purposes and under monitoring and control by the dealer.

<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>

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<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>

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<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>

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<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>

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<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>

No. It should not make a difference as pre-hedging in an appropriate manner should apply to both liquid and illiquid markets.

<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>

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<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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