TraderServe Responses to some questions from the ESMA call for evidence on pre-hedging

29th September 2022

Q1: 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.

We take the view that the suitability of the proposed definition of pre-hedging depends on whether the purpose is to characterise legitimate behaviour of the liquidity provider (pre-hedging) in contradistinction to illegitimate behaviour (front-running) or simply to describe an activity (pre-hedging) whilst leaving as an open question whether it could be legitimate. On the first interpretation there is a problem with clause (iv) that the activity be "undertaken, at least partially, in the interest and benefit of the client or to facilitate the trade": the motivation for anticipatory hedging is in the head of the liquidity provider and not generally capable of demonstration. On the other hand, if the idea is to give a raw description of pre-hedging behaviour (which may or may not be legitimate depending on circumstances) it would be better to drop (iv) altogether.

Q2: Do you believe the definition should encompass other market practices? Please explain.

Q3: Do you agree with the proposed distinction between pre-hedging and hedging?

Yes. The key distinction is that the risk mitigation of the anticipated order occurs before execution in the case of pre-hedging and after execution for hedging.

Q4: 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'?

While we believe that operation of "last look" functionality by liquidity providers gives them an unfair advantage over their clients, we do not see that it works to their advantage in circumstances where they have already pre-hedged their exposure on receipt of an RFQ.

Q5: What is your view on the arguments presented in favour and against pre-hedging?

Liquidity providers in receipt of RFQs from their clients are in a position of information asymmetry with respect to other market participants and should feel constrained not to use that additional information to profit their own accounts. Whether or not they should be free to pre-hedge depends, we believe, on the nature of the pre-hedging.

Where pre-hedging consists in merely trading in the underlying in comparable size to the RFQ and in the same direction, we believe the activity should be identified as front-running. As a result of the activity all additional risk of executing the client orders is eliminated which may enable them to offer a tighter quote but, where orders are large in size, they are very likely to cause price impact in the underlying and may be compelled to offer quotes at prices which are less advantageous to their client.

Where pre-hedging avoids simple front-running but nevertheless involves making trades in correlated instruments in the same direction as the incoming orders (or trades in negatively correlated instruments in the opposite direction) this too can cause price impact to the disadvantage of the client. Such activity should be regarded as a form of front-running in a statistical sense.

Where some more sophisticated risk-management regime is employed it is possible that pre-hedging can be justified from a risk-management perspective. It really depends on the form the pre-hedging takes. It ought, in any case, to be possible for the liquidity provider to offer an empirical justification for the activity in order to assure customers that they are receiving best execution.

Turning to the arguments in favour of pre-hedging, there may be merit in the suggestion that pre-hedging entails better quotes for the client but this shouldn't be accepted simply on the say-so of the liquidity provider. A tight quote on a front-run market may not be as advantageous to the party issuing the RFQ as a wider quote from a liquidity provider who is not "mitigating risk" on the forthcoming transaction.

Similarly one wonders whether there is real benefit to the client in making use of a market that is so illiquid it would not exist were it not for the freedom exercised by the liquidity provider to make use of the information contained in the RFQ before executing the client order. On such markets there is more likelihood that pre-hedging activity will cause substantial price slippage for the client sending the RFQ. There is also a concern that heavy pre-hedging in illiquid markets could adversely affect market integrity and contribute to market disorder.

Q6: In which cases could a foreseeable transaction enable a conclusion to be drawn on its effect on the prices?

Both an RFQ and an RFM contain information relevant to likely price movement subject to the foreseeable transaction. Sizeable RFQs are likely to have directional price impact, while sizeable RFMs may impact the volatility of underlying markets and thereby the price of derivative instruments such as options.

Q7: 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?

In line with the decision of the Court of Justice of the European Union we believe that "a particular item of information can be deemed to be precise even if it does not make it possible to predict whether the prices of the financial instruments concerned will increase or decrease, as long as a price variation is expected". *A fortiori*, where the liquidity provider who is in receipt of an RFM can determine the likely side of the forthcoming transaction the RFM should be regarded as "precise information".

Q8: 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?

We agree with ESMA that the size of the RFQ is key to the size of the potential market impact along with the type of trading, time of the day, volatility and liquidity. These are the most important factors.

Q9: Does the GFXC Guidance describe all the possible cases of risk management rationale that could justify legitimate pre-hedging? If not, please elaborate

We do not find any of the GFXC cases persuasive. We deal with them in turn.

Certainly, concerning (a), liquidity providers can reduce their market risk exposure by using the information in the RFQ. Indeed they could eliminate the additional risk of the anticipated order altogether by front running the forthcoming order into a strongly related market. But this is most likely to disadvantage their clients as it may adversely affect the prices that they are quoted.

As to (b), again this looks at things exclusively from the liquidity provider's perspective. That they can reduce their hedging costs by starting his hedging before executing the order comes as no surprise, but this observation hardly justifies the practice if it means that their clients get poorer quoted prices as a result of market movement prior to their orders' execution.

In cases where underlying liquidity is low, the very tests of liquidity as envisaged in (c) are likely to result in a poorer price for the client in consequence of the market movement prior to execution. Again the client is likely to be disadvantaged.

Q10: Can you identify practical examples of pre-hedging practices with/without a risk management rationale?

Q11: 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?

The liquidity provider would be attempting to improve its own portfolio by taking advantage of information which is available only to the small number of dealers contacted by the client who wants to trade. If the liquidity provider knows it is not going to be asked to execute then the usual justification – viz. that it can offer a better price for the client as a result of the pre-hedge - falls away. It would simply be trading on its own account in a situation of asymmetric information with most other market participants. Furthermore the effect of the "hedge" could well have an adverse effect on the price that the client is quoted by the other liquidity providers.

Q12: Can you identify financial instruments that should/should not be used for prehedging purposes? Please elaborate

Q13: Please provide your views on the proposed indicators of legitimate and illegitimate pre-hedging. Would you suggest any other?

Certainly the client's express consent to pre-hedging conduces to the legitimacy of the practice by liquidity providers but more important is the suggestion that pre-hedging only be used in the interests of the client. The problem with this is that liquidity providers may believe they are acting in the interests of their client when they pre-hedge, whereas the prices they quote to their client are in general not as good as might have been possible before the risk management activity was undertaken. Liquidity providers could examine this possibility with real world data. We believe that it would remove what are otherwise strong objections to the practice of pre-hedging were the liquidity providers required to undertake such research and share it with their customers.

Q14: 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?

Q15: 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?

A pre-hedge in any market strongly correlated with the market in question operates as front-running or statistical front-running (see our response to Q5). Such activity is mostly in the interest of the liquidity provider. As we argued in our response to Q5, we doubt that the client achieves much, if any benefit, from such activity. Any pre-execution activity in substantial size which is undertaken by the liquidity provider to reduce exposure to a forthcoming order is likely to have an adverse effect on price for the customer.

Q16: 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.

We see no reason why liquidity providers should not provide evidence of all of these. In particular, if they claim that their pre-hedging allows them to quote better prices for their clients, then they should be able to offer appropriate empirical evidence.

Q17: 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.

We doubt that the risk management rationale (that the liquidity provider can offer better quotes to its clients if he is allowed to pre-hedge) is any stronger for illiquid instruments. It is these instruments that are most vulnerable to substantial price impact from the pre-hedging activity before the execution of the client order. This impact is likely to remove any benefit accruing to the client from the tighter quote that the liquidity provider is able to offer.

Q18: 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?

Q19: 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.

Q20: 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?

Q21: 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?

Q22: 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?

Q23: Would you like to highlight any specific issue related to the obligation to provide clear and not misleading information?

Q24: Should ESMA consider any other element with respect to pre-hedging and systematic internalisers and OTFs? Please elaborate