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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 | AFG (French Asset management Association) |
| Activity | Investment Services |
| Are you representing an association? |  |
| Country/Region | France |

**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>

Yes, assessing the underlying principle, our members think that front running should be proscribed in whatever form and that liquidity providers should establish ( if not already existent as per applicable regulations ) conduct rules to ban those practices and ensure that they have a robust framework in place to guarantee that the pre-hedging will not disadvantage the client nor have a harmful impact on the market prices.

<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>

Whereas our membership does not 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 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 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>

Please see answer to question 1

<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>

Difficult to answer as of course information from 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.

<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>

Members believe that size of the trade versus market available liquidity and overall risk of the trade should be taken into account.

If a RFQ is done on a size which is big 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 principals 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 different functioning of markets no one-size fits all approach should be used 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>

No answer provided

<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 is considered to be front running. Where a liquidity provider cannot reasonably assume that it will win an RFQ it 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>

Our members can see reason for pre- hedging on an exceptional basis, subject to some degree control that can be exercised by and evidence delivered to the client and in such case, no rationale for us 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>

We agree that the pre-hedging should only be used for risk management purposes with the Liquidity provider acting as principal, where there is a likehood of the underlying transaction going ahead and when it is in the interests of the client to do so. Liquidity can be a relevant factor but should not be a prescriptive one, relying on a binary liquid/illiquid approach.

<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, in such circumstances, buy side clients would not chose to go electronic and would adapt their RFQ process to the specificity of the trade being contemplated to preserve confidentiality and leave some room for the counterparty to recycle the risk;

<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.

<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 code of conducts, get organized to be supervised and being in 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

<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>

AFGs 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>

No answer provided

<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>

No answer provided

<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>

NO

<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>

No answer provided

<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>

NO

<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>

NO

<ESMA\_QUESTION\_PHDG\_24>