European Securities and Markets Authority

Response Form to the Call for evidence on pre-hedging

29 July 2022 ESMA | ESMA 70-449-674

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 under the heading 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.

General information about respondent

Name of the company / organisation	Global FX Division
Activity	Other Financial service providers
Are you representing an association?	☒
Country/Region	UK

Questions

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.

<ESMA_QUESTION_PHDG_1>
The Global Foreign Exchange Division ('GFXD') of the Global Financial Markets Association ('GFMA') welcomes the opportunity to provide comments to ESMA's Call for Evidence on pre-hedging.

The GFXD was formed in co-operation with the Association for Financial Markets in Europe ('AFME'), the Securities Industry and Financial Markets Association ('SIFMA') and the Asia Securities Industry and Financial Markets Association ('ASIFMA'). Its members comprise 24 global FX market participants [1], collectively representing the majority of the FX inter-dealer market [2] (according to Euromoney league table).

For FX, we support the existing definition, as per the FX Global Code (July 2021) [3]; this will minimize legal discrepancies and allow harmonisation in practices across jurisdictions, which is essential for cross-border markets like FX.

We would like to reiterate that, consistently with the FX Global Code, firms only pre-hedge when they act in a principal capacity and in a way that does not disrupt the functioning of the market.

Additionally, the GFXC Commentary on Principle 11 [4] states that "*The amount of any pre-hedging should be commensurate with the potential risk assumed by the liquidity provider from the anticipated order and the prevailing liquidity and market conditions for the specific currency pair. Factors that could be potentially considered in deciding whether pre-hedging could be used to manage the risk of an anticipated order, include whether the potentially transaction is:*

1. *Large relative to the liquidity provider's risk limits.*
2. *Large relative to normally available market liquidity for the particular FX pairing.*
3. *Requested during a relatively illiquid time of day, or when general market conditions are otherwise illiquid*".

Therefore, firms consider different factors when deciding to pre-hedge.

[1] Bank of America, Bank of New York Mellon, Barclays, BNP Paribas, Citi, Credit Agricole, Credit Suisse, Deutsche Bank, Goldman Sachs, HSBC, ING, JP Morgan, Lloyds, Mizuho, Morgan Stanley, MUFG Bank, NatWest Markets, Nomura, Northern Trust, RBC, Standard Chartered Bank, State Street, UBS and Wells Fargo
[2] According to Euromoney league table.
[3] https://www.globalfxc.org/docs/fx_global.pdf
[4] https://www.globalfxc.org/docs/commentary_principle_11_role_prehedging.pdf
<ESMA_QUESTION_PHDG_1>

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

<ESMA_QUESTION_PHDG_2>
No, for FX, we support the existing definition included in the FX Global Code.
<ESMA_QUESTION_PHDG_2>

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

<ESMA_QUESTION_PHDG_3>
For FX, we recommend aligning with the distinction mentioned in the Global FX Code (July 2021), which refers to "*any trading activity after the acceptance of the firm quote by the liquidity consumer is deemed hedging*".
<ESMA_QUESTION_PHDG_3>

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'?

<ESMA_QUESTION_PHDG_4>
For FX, we do not have any specific concerns in relation to "last look", as any risk of potential market abuse activities during the "last look" time window is addressed under Principle 17 of the Global FX Code (July 2021). Principle 17 specifically refers to a situation where the liquidity consumer is sending a specific order requesting to trade on an indicative quote already provided and, therefore, the liquidity provider has access to confidential information.
<ESMA_QUESTION_PHDG_4>

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

<ESMA_QUESTION_PHDG_5>
We support AFME's response to question 5.

With a particular focus on FX, moreover, , we support and would like to reference the text in the FX Global Code, specifically Principle 11 '*A Market Participant should only Pre-Hedge Client orders when acting as Principal* and should *do so fairly and with transparency'* as well as the text included in the July 2021 GFXC paper 'Global Foreign Exchange Committee: Commentary on Principle 11 and the role of pre-hedging in today's FX landscape'. We believe both texts, including examples of illustrative trading scenarios, provide a good summary of both the benefits and impacts of pre-hedging. We note the wide adherence to the FX Global Code across the global sell side sector and recommend that ESMA consider these texts and examples in their analysis.

The 2021 GFXC paper was written '*by the GFXC in response to that need specifically, to help provide further clarity on the appropriate use of pre-hedging in today's FX landscape, including (i) how it is defined, (ii) when it could be used, and (iii) the potential impact that it could have on the prices quoted to the liquidity consumer*.' The 2021 GFXC paper also states that '*Pre-hedging, in the context of a one-way RFQ, comprises any associated trading activity that takes place between the time that the liquidity consumer requests the firm quote and before the liquidity consumer accepts the quote (creating a confirmed transaction), or rejects the quote*.'

As per Principle 11 in the Code, pre-hedging '*is not meant to disadvantage the client or disrupt the market'*. This statement is further developed in the 2021 GFXC paper, in which the GFXC notes that '*The intent of any pre-hedging by the liquidity provider should always be to benefit the liquidity consumer and help facilitate the transaction'*, whilst also recognising that '*Despite an intent by the liquidity provider to provide a benefit to the liquidity consumer and to limit the market impact of a trade, pre-hedging may result in an adverse outcome for the liquidity consumer depending on the circumstances'*. In addressing the arguments against pre-hedging in relation to 'information leakage' in sections 18-23, we note that the benefit of pre-hedging is to benefit the client, therefore trading activity to leverage the information for the benefit of the bank without the intent of dealing without benefitting the client would be considered contrary to the advice provided under the Code and the FMSB paper [5].

Both the FX Global Code and the 2021 GFXC paper also recognise the importance of transparency and communication, for example '*liquidity providers should only pre-hedge anticipated orders "when acting as a Principal, and should do fairly and with transparency'*. Transparency as to how their orders are handled will enable clients to make informed decisions on how to trade; for example, as the 2021 GFXC paper notes that if a client is concerned about the potential market impact of pre-hedging, they can make an informed decision on which liquidity provider(s) to RFQ.

[5] https://fmsb.com/wp-content/uploads/2021/05/FMSB_Large_Trades_Standard_-FINAL-05.05.21.pdf

<ESMA_QUESTION_PHDG_5>

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

<ESMA_QUESTION_PHDG_6>
We support AFME's response to question 6.

Additionally, we would like to note that (i) it is incorrect to assume that a RFQ implicitly contains inside information simply by virtue of being a RFQ. Whether a particular fact pattern is MAR relevant should be assessed against the criteria set out in MAR, bearing in mind that Art.7.1(d) of MAR only refers to pending orders, not RFQs; and (ii) considering RFQs as inside information is inconsistent with the nature of RFQs, which are used by clients to make their investment decisions in public markets.
<ESMA_QUESTION_PHDG_6>

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?

<ESMA_QUESTION_PHDG_7>
Should the firm have information on the client through previous commercial relationships, it might still not be exhaustive enough to infer the intentions of the client and, therefore, the information cannot be considered sufficiently precise as per the MAR definition. On the contrary, RFMs should continue to be treated on a case-by-case basis.
<ESMA_QUESTION_PHDG_7>

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?

<ESMA_QUESTION_PHDG_8>
Please see our response to question 6.
<ESMA_QUESTION_PHDG_8>

Q9 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>
For FX, we believe that the FX Global Code and the FMSB Standards (Annex 1 – "Examples of risk management activity") provide a good overview of the primary recognised cases of risk management rationale.
<ESMA_QUESTION_PHDG_9>

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

<ESMA_QUESTION_PHDG_10>
As per the FX Global Code, which defines pre-hedging as "*the management of the risk associated with one or more anticipated Client orders, designed to benefit the Client in connection with such orders and any resulting transactions*"", pre-hedging is undertaken only when there is a risk management rationale behind, and it is designed to benefit the clients.
<ESMA_QUESTION_PHDG_10>

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?

<ESMA_QUESTION_PHDG_11>
For FX, we would agree in principle that pre-hedging should not be undertaken if the firm is aware they would not be awarded the transaction. However, firms would not pre-hedge if they knew they would not be awarded the transaction for the following reasons.

Firstly, as per the FX Global Code, firms can "anticipate in good faith" whether they will be awarded the trade and, therefore, base their pre-hedging strategy accordingly. If they thought they would not win the transaction, they would not choose to provide a quote at all, considering their risk management rationale.

Secondly, firms would pre-hedge in order to provide the quote, taking ownership of the risk in a principal capacity, and leaving the clients with the possibility to reject the quote. This makes clients' intentions always uncertain to some extent and hard to predict whether the firm will be awarded the transaction.
<ESMA_QUESTION_PHDG_11>

Q12 Can you identify financial instruments that should/should not be used for pre-hedging purposes? Please elaborate

<ESMA_QUESTION_PHDG_12>
For FX, there is no general market practice to define which financial instruments should be used for pre-hedging purposes as this would be addressed on a case-by-case basis depending on the risk management strategy.
<ESMA_QUESTION_PHDG_12>

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

<ESMA_QUESTION_PHDG_13>

For FX, we are of the view that the FMSB Standards already provide a set of criteria for identifying when pre-hedging activities are allowed, specifically under Principle 7 (i.e. […] "*all cases where (i) the market maker has a legitimate expectation to take on market risk and pre-hedging is undertaken at its own risk; (ii) when the trading activity is reasonable relative to the size and nature of the anticipated transaction; (iii) when pre-hedging aims at minimising the impact of the activity on the market; and (iv) when this is designed to benefit the counterparty/client*").

Moreover, market participants can also refer to the Global FX Code (July 2021), under the section "Controls and Disclosures around pre-hedging", which provides a list of procedure to undertake in order to fairly handle client orders. Consequently, pre-hedging activities which are compliant with the Code should be considered legitimate.
<ESMA_QUESTION_PHDG_13>

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?

<ESMA_QUESTION_PHDG_14>
No, for FX, given both the large amounts of RFQs that firms receive, and the large number of RFQs clients submit (including to multiple firms), requesting consent would not be manageable on a trade-by-trade basis, as it would make the trade process extremely lengthy, while requesting a quote is typically a fast-paced process, potentially sub-second for electronic RFQs.

However, to ensure transparency, firms have public disclosures on their website regarding their pre-hedging practices. Moreover, the GFXC Commentary on Principle 11 clearly states that "liquidity providers should have in place procedures for handling client orders fairly and in accordance with the Code, including all the applicable Principles. These procedures are part of an appropriate control and compliance framework". Compliance with the guidance included in the Commentary and Principle 11 itself helps pre-hedging clients' orders "fairly and with transparency", while ensuring a fast-paced RFQ process.
<ESMA_QUESTION_PHDG_14>

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?

<ESMA_QUESTION_PHDG_15>
As noted in the FX Global Code (July 2021), under Principle 11, pre-hedging is "designed to benefit the client" and therefore it is not conducted mostly in the interest of the liquidity provider. This is consistent with the criteria listed in the FMSB Standards (i.e. […] "*all cases where (i) the market maker has a legitimate expectation to take on market risk and pre-hedging is undertaken at its own risk; (ii) when the trading activity is reasonable relative to the size and nature of the anticipated transaction; (iii) when pre-hedging aims at minimising the impact of the activity on the market; and (iv) when this is designed to benefit the counterparty/client*").
<ESMA_QUESTION_PHDG_15>

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.

<ESMA_QUESTION_PHDG_16>
For FX, we do not think this is feasible, as any legal guidance in relation to pre-hedging is principle-based and, hence, does not prescribe how to measure and calculate the benefits provided to the clients.

Moreover, as stated under question 11, pre-hedging activity is not simply linked to one specific transaction. On the contrary, as per Principle 11 of the FX Global Code, "[…] when considering whether Pre-Hedging is being undertaken in accordance with the principles above, pre-Hedging of a single transaction should be considered within a portfolio of trading activity, which takes into account the overall exposure of the Market Participant". This adds another layer of complexity to provide evidence on the four proposals above.

By way of example, the expectation to conclude the transaction and the risk management needs behind the transactions can be understood in the context of the conditions of the trades and existing/previous commercial relationships with the clients. Those are not quantitative criteria which can be used to provide evidence.

Finally, we would like to reiterate that, while pre-hedging is conducted with the intention of benefitting the client, as per the FX Global Code, it would be extremely difficult to measure the outcome for the client due to potential market movements. Indeed, as per the GFXC Commentary on Principle 11, "Despite an intent by the liquidity provider to provide a benefit to the liquidity consumer and to limit the market impact of a trade, pre-hedging may result in an adverse outcome for the liquidity consumer depending on the circumstances".
<ESMA_QUESTION_PHDG_16>

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.

<ESMA_QUESTION_PHDG_17>
For FX, we do not believe that the liquidity of a financial instrument should be considered as an indicator of legitimacy, and we see challenges with this proposal.

Firstly, even though pre-hedging seems to be understood in the context of illiquid products, it brings different benefits for liquid and illiquid markets. In the first case, pre-hedging is mostly used for risk management purposes which are intended to benefit the clients through (but not only) better pricing. On the other hand, as ESMA noted in the Call for Evidence, the market for illiquid financial instruments (e.g. illiquid currencies) might disappear if pre-hedging activities were prohibited or limited, concentrating the market across fewer dealers, potentially resulting in more volatile prices.
Moreover, as previously stated under question 5, pre-hedging is also beneficial for markets where the liquidity has been exhausted.

Secondly, the distinction between liquid and illiquid products is often very challenging, even when using the definition of liquidity under MiFID.

As another layer of complexity, other factors come into play when choosing to pre-hedge, such as:

1. The trade size
2. The ability of the dealer to access that liquidity
3. Other RFQs the dealer has around the same level at the same time
4. Time to transact
5. Impact of the transaction on prices

This makes defining a list of indicators more complicated, as factors might vary from trade to trade. As a general rule however, and to ensure compliance with the FX Global Code, pre-hedging is always commensurate to the potential risk.
<ESMA_QUESTION_PHDG_17>

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?

<ESMA_QUESTION_PHDG_18>
For FX, based on members' experience, market participants also pre-hedge for transactions against retail and professional clients, as it depends on the potential risk that they are assuming.
<ESMA_QUESTION_PHDG_18>

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.

<ESMA_QUESTION_PHDG_19>
Yes, firms already have policies in place to address conflict of interest as per MiFID. For instance, the policies refer to the control of information, the Need to Know principles, segregated desks, record keeping and surveillance.
<ESMA_QUESTION_PHDG_19>

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?

<ESMA_QUESTION_PHDG_20>
Please refer to our answer under question 14.
<ESMA_QUESTION_PHDG_20>

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?

<ESMA_QUESTION_PHDG_21>

For FX, there are currently no standardised market practices on offering quotes with and without pre-hedging. Furthermore, depending on the risk, firms might not provide a price without pre-hedging as they might not have the commercial ability to take on the risk.
<ESMA_QUESTION_PHDG_21>

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?

<ESMA_QUESTION_PHDG_22>
In line with MiFID record keeping requirements, firms are required to record regulated activity and trades in internal systems. Furthermore, surveillance and trade reconstruction could be used to aggregate the relevant details.
Firms are expected to comply with these requirements to evidence that pre-hedging activities are in line with both client disclosures and Principle 11 of the FX Global Code, which refers to the responsibility of the firm to pre-hedge client orders "fairly and with transparency".
<ESMA_QUESTION_PHDG_22>

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

<ESMA_QUESTION_PHDG_23>
We support AFME's response for question 23.
<ESMA_QUESTION_PHDG_23>

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

<ESMA_QUESTION_PHDG_24>
We support AFME's response to question 24.
<ESMA_QUESTION_PHDG_24>