# FESE Response - ESMA Call for Evidence on pre-hedging

Brussels, 26th September 2022

## 2. Working definition of pre-hedging

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.

FESE welcomes the ESMA's call for evidence on pre-hedging in view of the importance of clarifying and delimiting this market practice.

As a general remark, FESE is aligned with ESMA's views expressed in the last Consultation on the MAR Review that 'pre-hedging' can cause risk of potential market abuse, competition distortion among brokers ("un-level playing field"), severe market distortion, information leakage, allowance for insider information and creation of slippage costs for investors. However, as also acknowledged, this practice can lead to beneficial outcomes in certain markets and cases, which we suggest are properly delineated (e.g. see response to Q5).

In this context, FESE would like to stress the value of developing a concise definition, agreed by market participants, covering what is considered to be permitted in relation to pre-hedging. This would help market authorities to effectively monitor and identify instances of potential market abuse, according to our understanding, but also the market participants.

In addition, it would be essential that 'pre-hedging' and 'front-running' are clearly differentiated (see response to Q2). Besides, MAR does not provide a proper distinction between insider dealing (Article 8 of MAR) / conflicts of interest (Article 12 of MAR) and pre-trading, which should also be addressed.

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

As stated in Q1, FESE supports the development of a concise definition, agreed by market participants, that covers what is considered to be permitted in relation to pre-hedging. This would help market authorities to effectively monitor and identify instances of potential market abuse, but also the market participants.

However, for the above to be achieved, the definition of 'pre-hedging' should be very well delimited from other market practices that may lead to confusion, such as 'front-running'. To this end, future definitions should also clarify which actions could be considered as (illegitimate) 'front-running' to clearly differentiate between these two notions, as a necessary step to avoid misinterpretation and to define the scope of acceptable behaviour. As a result, potentially affected market participants would be in a better position to avoid unintended illegitimate behaviour.

In the case of 'front running', FESE believes it would be helpful to clarify situations where liquidity contracts are in place with the issuer of illiquid securities, and that in these circumstances where a liquidity provider is facilitating the retail flow by providing additional liquidity, this is not considered front-running. We understand there will have

to be strict controls in place to ensure that this is not taken advantage of, but it would be helpful to have clarity on this situation.

In addition, we believe there are several scenarios in which one market participant may disclose their interest in a financial instrument selectively to another market participant or a limited set of market participants, in addition to RFQ. First, where a market participant bilaterally requests a quote from another market participant, for example where a buy-side client bilaterally requests a quote from their salesperson at a sell-side firm. This activity often occurs with Systematic Internalisers (SIs) and over-the-counter (OTC) but is very similar to the way in which market participants request a quote on a trading venue with an RFQ trading system or similar trading system. Second, when a market participant sends an order to an interdealer broker. Where these interdealer brokers operate trading venues (typically OTFs) they are likely to be designed as voice trading systems, or at least not as an RFQ trading system. In summary, if the focus remains solely on activity on trading venues operating RFQ trading systems rather than more broadly on the activity of one market participant disclosing their interest in a financial instrument selectively to a limited set of market participants, ESMA risks adopting a scope which is too narrow for its guidance. Any new rules or guidance should be system and technology agnostic. Otherwise, these rules will not be appropriately scoped, to the detriment of fair and orderly markets and investor protection. An un-level playing field could also shift activity away from regulated RFQ trading venues to SIs and OTC.

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

**3. State of play and market views on the need for pre-hedging**

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

Regarding the arguments in favour of pre-hedging, FESE would like to stress that 'pre-hedging' could yield beneficial outcomes in certain types of markets and hence it may also be important to distinguish between them.

For example, FESE can observe that market participants are at times trying to facilitate trading in markets where it is not always simple to readily see prices, for example in less liquid options markets, where investors need the support of brokers, and where liquidity providers/ market makers provide prices to what is demanded and could wrongly be understood as front-running. Forming an ecosystem where investors, brokers and liquidity providers interact in a triangle could result in beneficial outcomes as well should not be considered as 'front-running', but rather be delineated.

To this backdrop, FESE would support that market practices that can help the market, especially in less liquid instruments, and its participants could fall under an envisaged concise exception. However, liquidity should not be seen as the main and single criteria for the legitimation of pre-hedging as there could be significant price movements even in the liquid markets if the requested quantity is large enough. Therefore, the liquidity shall be taken into account (at least) together with the requested quantity to be traded.

In addition, FESE would support ESMA being able to identify and delineate potential types of drawbacks and benefits of 'pre-hedging' in the particular case of constellations. Further, FESE would also find it valuable to delineate those cases where pre-hedging has negative consequences for the market, as well as to propose mitigation measures that support positive outcomes.

Last, but not least, ESMA has referred in the Call for Evidence paper to the approaches taken by FINRA (USA), Canada and the GFXC principles, among others. In this context, FESE would encourage ESMA to take into account existing regulations in other jurisdictions as well as established industry standards with a view to ensure a common understanding and international coherence.

**4. Pre-hedging and MAR**

*4.1. RFQs as inside information*

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

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?

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 believe there are several scenarios in which one market participant may disclose their interest in a financial instrument selectively to another market participant or a limited set of market participants, in addition to RFQ. First, where a market participant bilaterally requests a quote from another market participant, for example where a buy-side client bilaterally requests a quote from their salesperson at a sell-side firm. This activity often occurs with Systematic Internalisers (SIs) and over-the-counter (OTC) but is very similar to the way in which market participants request a quote on a trading venue with an RFQ trading system or similar trading system. Second, when a market participant sends an order to an interdealer broker. Where these interdealer brokers operate trading venues (typically OTFs) they are likely to be designed as voice trading systems, or at least not as an RFQ trading system. In summary, if the focus remains solely on activity on trading venues operating RFQ trading systems rather than more broadly on the activity of one market participant disclosing their interest in a financial instrument selectively to a limited set of market participants, ESMA risks adopting a scope which is too narrow for its guidance. Any new rules or guidance should be system and technology agnostic. Otherwise, these rules will not be appropriately scoped, to the detriment of fair and orderly markets and investor protection. An un-level playing field could also shift activity away from regulated RFQ trading venues to SIs and OTC.

*4.2. Indicators of legitimate and illegitimate behaviour under MAR*

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

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?

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

As further explained in Q5, 'pre-hedging' could yield beneficial outcomes in certain types of markets and, in this context, a possible conditional allowance for these could prove to be advantageous. In particular, this could be the case for less liquid instruments (e.g. less liquid options markets), where market participants sometimes try to facilitate trading, as it is not always simple to readily see prices. For example, in these scenarios, market makers provide prices at what is demanded, which should not be understood as front-running. In conclusion, investors, brokers and liquidity providers interact in a 'triangle' in these less liquid markets could lead to positive outcomes, and hence they could fall under an envisaged concise exception.

However, liquidity should not be seen as the main and single criteria for the legitimation of pre-hedging as there could be significant price movements even in the liquid markets if the requested quantity is large enough. Therefore, the liquidity shall be taken into account (at least) together with the requested quantity to be traded.

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

As reflected in Q2, FESE Members consider it of utmost importance that the upcoming definition of 'pre-hedging' clearly differentiates this practice from 'front-running'. This is a necessary step to avoid misinterpretation and to define the scope of acceptable behaviour so that potentially affected market participants can be in a better position to avoid unintended illegitimate behaviour.

In this context, and as the consultation paper acknowledges, due consideration of the 'interest of the client' is required.

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?

No, in the context of electronic and competitive RFQs, we are not aware of consent to pre-hedging being provided on a case-by-case basis.

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?

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.

*4.3. Is the liquidity of the instrument an indicator of possible illegitimate behaviour?*

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.

See response to Q12.

**5. Pre-hedging and MiFID/ MiFIR**

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?

We believe there are several scenarios in which one market participant may disclose their interest in a financial instrument selectively to another market participant or a limited set of market participants, in addition to RFQ. First, where a market participant bilaterally requests a quote from another market participant, for example where a buy-side client bilaterally requests a quote from their salesperson at a sell-side firm. This activity often occurs with Systematic Internalisers (SIs) and over-the-counter (OTC) but is very similar to the way in which market participants request a quote on a trading venue with an RFQ trading system or similar trading system. Second, when a market participant sends an order to an interdealer broker. Where these interdealer brokers operate trading venues (typically OTFs) they are likely to be designed as voice trading systems, or at least not as an RFQ trading system. In summary, if the focus remains solely on activity on trading venues operating RFQ trading systems rather than more broadly on the activity of

one market participant disclosing their interest in a financial instrument selectively to a limited set of market participants, ESMA risks adopting a scope which is too narrow for its guidance. Any new rules or guidance should be system and technology agnostic. Otherwise, these rules will not be appropriately scoped, to the detriment of fair and orderly markets and investor protection. An un-level playing field could also shift activity away from regulated RFQ trading venues to SIs and OTC.

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.

As explained in more detail in Q8, it is essential that pre-hedging should be regulated in a system and technology-agnostic manner, regardless of the way the pre-hedging liquidity provider gets to know of the possible trade in the future. This means that not only RFQ systems should be covered, but also other scenarios - such as in OTC negotiations, SIs, etc – in which one market participant also discloses its buying/selling interest in a financial instrument selectively to another market participant or a limited set of market participants.

Taking this into account when regulating pre-hedging is crucial for a level playing field. Otherwise, the rules will not be appropriately scoped, to the detriment of fair and orderly markets and investor protection, and a shift of activity from regulated RFQ trading venues to SIs and OTCs.