ESMA
Call for evidence
On pre-hedging

AMAFI's answer

Association française des marchés financiers (**AMAFI**) is the trade organisation working at national, European and international levels to represent financial market participants in France. It mainly acts on behalf of credit institutions, investment firms and trading and post-trade infrastructures, regardless of where they operate or where their clients or counterparties are located. AMAFI has 170 members operating in equities, fixed-income and interest rate products, as well as commodities, derivatives and structured products for both professional and retail clients. Nearly one-third of its members are subsidiaries or branches of non-French institutions.

AMAFI welcomes the opportunity to comment ESMA's Call for Evidence (CfE) on pre-hedging. Before answering to the specific questions of ESMA's consultation document, AMAFI would like to point out the following general comments.

1. GENERAL COMMENTS

Pre-hedging practices are essential for the good functioning of financial markets because they serve to provide liquidity, while enabling investment services providers (ISPs) to manage their risk and thus propose prices as attractive as possible. Without the possibility to pre-hedge, many ISPs would not be in a position to answer clients' RFQs because this would lead to too much risk taking and/or clients would be at a detriment, as the spread offered would widen. This practice thus ultimately serves the interest of issuers and investors, as it allows for better price quotes and the existence of these very same price quotes.

Therefore, AMAFI finds it of the utmost importance that **pre-hedging practices are not systematically viewed as insider dealing.** We read this call for evidence as an implicit acknowledgement by ESMA that it has not formed such a view and would thus call on ESMA to communicate officially on this.

AMAFI would also like to draw ESMA's attention on the fact that any further **clarification brought on pre-hedging practices should not prevent (ISPs) from managing their inventory' risk,** based on publicly available information or on their anticipations. It is of primary importance that a liquidity provider (LP) that has been questioned by a client through an RFQ on a specific financial instrument should not be prevented from conducting its usual inventory management, on the same financial instrument. Otherwise, it would then not be in a position to carry out its function of continuously providing two ways quotation on financial instruments, hence providing liquidity. In that respect, it is important to note that pre hedging a future transaction, like hedging a transaction, is not necessarily done through one for one transactions, as inventory risks are also managed more globally, considering the resulting positions of different desks.

Finally, because the questions about pre-hedging are intrinsically connected with the ones about characterization of insider dealing in the sense of front running, and more generally with the characterization of inside information, AMAFI would like to call for not rebuilding a specific new concept and regime. Therefore, as is currently the case for identifying inside information or insider dealing, the potential **future guidance on pre hedging should rely on a case- by-case-approach considering the specifics of each situation, rather than adopting a standardized approach that would anyhow fail to consider all possible facts.**

2. RESPONSES TO ESMA QUESTIONS

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.

AMAFI supports the general definition provided under paragraph 6.

However, to AMAFI, case ii) under paragraph 9, should not always be viewed as pre-hedging since our understanding is that in the case described, the LP will start to trade only after he is certain to conclude a deal with the client. In AMAFI's view, this amounts to hedging and not pre-hedging which does not cause the issues at stake in the present CfE.

Indeed, the case (ii) in the CfE refers to instances "where a trade has been agreed by the client and the liquidity provider but some elements of the trade (e.g., price) will be specified at a later stage". In the case where the LP has the certainty to deal and only the price is to be determined, the risk is known, and the situation does not correspond to pre-hedging. However, if the size of the transaction is not known then the risk cannot yet be determined. It could then be possible to consider that there is room for pre-hedging transactions.

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

No.
Moreover, as previously stated under Q1, AMAFI is of the view that the practice described under case ii) paragraph 9 should not be viewed as a pre hedging practice because in the case described, the LP will start to trade only after he is certain to conclude a deal with the client. In AMAFI's view, this amounts to hedging and not pre-hedging.

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

No, AMAFI does not agree with the distinction made under § 13 of the CfE. To us, the distinction between hedging and pre-hedging should be based on the position in time of hedging transactions compared to the point in time where the agreement between the parties to conclude the deal occurs.
For that reason, to us, the 4th column of the table under § 16 should be deleted.

Another issue on which AMAFI would like to draw ESMA's attention is that LPs, in the course of their day-to-day market making activities, need to continuously monitor their inventory on all financial instruments on which they provide liquidity. As pointed out in our general comments, further rules on pre hedging should not impair such necessary management. Therefore, the table provided under § 16 should be amended to better reflect that pre-hedging transactions are not all the transactions occurring after a certain point in time, even if concluded for risk monitoring purposes, but only those **undertaken to mitigate an inventory risk stemming from a possible transaction.** An ISP might legitimately conclude transactions for global inventory hedging purposes and such transactions should not be caught by pre-hedging potential rules or guidance. As a consequence, the terms *"trading activities"* used in the second line of the table presented under §16 for the description of the different cases should cross refer to the general definition recalled I the first line of the table.

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'?

AMAFI supports the guidance provided by GFXC on pre hedging practices in the context of "last looks" and agrees that such practices should in all cases not be viewed as legitimate (and not only for FX transactions which is its current application scope).

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?

AMAFI agrees with the advantages of pre-hedging presented under paragraphs 24 to 28 of the CfE, and wishes to add that the possibility to pre hedge a transaction is sometimes a sine qua non condition for a liquidity provider to be in a position to answer an RFQ. AMAFI would therefore like to warn on the risk that a mere ban of pre hedging transactions might have a very detrimental effect on the market.

As for the arguments against pre-hedging presented under paragraph 3.1, AMAFI has the following comments:

- With regard to paragraph 20: in most cases, pre-hedging practices do not deteriorate the price offered to clients: conversely, the price that would be provided by LPs in the absence of any visibility on their hedging conditions is likely to encompass a significant markup or markdown aimed to cover that risk. Therefore, in such a case, the bid/offer spreads are likely to be broader, to the detriment of the clients, than it would be with pre-hedging transactions.
- As to paragraph 21 stating that "*respondents highlighted that the risks of insider dealing in the form of front running behaviours appear more pronounced when an RFQ is sent for liquid or very liquid assets, where a clear risk management rationale does not seem to exist*", AMAFI would like to point out that risk management rationale can also exist on liquid financial instruments, depending on the size of the transaction,

As stated under our general comments, pre-hedging practices are essential for the functioning of markets as they form the sine qua non condition to provide liquidity to the market, which ultimately serves the interest of investors and issuers.

PRE-HEDGING AND MAR

- *RFQs as inside information*

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

First of all, AMAFI would like to draw ESMA's attention on the fact that assimilating RFQs to inside information would constitute a significant change to MAD/MAR framework, that would deserve thorough assessment and market consultation, and should not be decided through a Request for Evidence. As a consequence, pre-hedging transactions should not systematically be viewed as insider dealing.

Moreover, whereas AMAFI agrees overall with the developments under paragraphs 12 to 16, it also wishes to draw ESMA's attention on the fact that MAR L1 and L2 provisions on inside information and case of law might provide sufficient guidelines and that any more specific provisions run the risk to be inappropriate in a certain number of cases.
Practice and jurisprudence have long shown that qualifying an information either as inside or non -inside is an art and not a technique and therefore needs a case-by-case assessment. This is no different in the case of pre-hedging.

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?

Please see our answer to Q6.

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?

Please see our answer to Q6. The size of a potential transaction or the liquidity of the financial instruments concerned cannot by themselves and independently of other factors be viewed as sufficient to conclude on the possible market impact of a transaction. This has to be assessed on a case-by-case basis, depending on many factors including liquidity, type of financial instruments, size of the transaction, relevant news on the market…Such factors can evolve rapidly and therefore must be assessed on a case-by-case basis considering the specific market conditions.
Moreover, setting a list of factors would be counter-productive, as such list would require frequent review, if only to keep track of market innovation.

- *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

AMAFI agrees on the point that pre hedging does not make any sense when a firm is acting as agent and therefore will not incur any inventory risks.

However, we doubt that the GFXC guidance which is focused on a specific market would provide all possible cases encountered on all markets. The FX market is characterized by extremely high volumes and high liquidity, which is not comparable to other markets.

AMAFI is also of the view that trying to draw an exhaustive list of cases where risk management rationale would be acceptable is likely not to be a constructive way forward, due to the specificity of the different situations encountered that should be assessed on a case-by-case basis.

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

No.

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?

No. However, ESMA should consider that assessing the probability that the transaction will not be awarded might not always be a straightforward exercise.

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

Again, to AMAFI, the choice of financial instruments that could be used for pre-hedging purposes should be assessed on a case-by-case basis.

However, AMAFI would not oppose a clarification that trading on highly diversified financial instruments would be viewed as an indicator of legitimacy for pre hedging transactions on single name financial instruments, due to the low correlation between the two instruments.

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

AMAFI would first like to stress that it is extremely important, as suggested under § 22 and 23, that the legitimacy of a hedging practice, which basically raises a risk of misuse of inside information, is assessed with sufficient scrutiny. Along these lines, if ESMA was to publish a list of criteria of legitimacy or illegitimacy, it seems essential that such a list would be presented as non-exhaustive and non-binding (meaning that the fulfilment of the list would not be considered as sufficient to conclude on the legitimacy) and there would still be room for a case-by-case approach. It should also be clarified that conversely, a transaction that would not fulfil the whole list of indicators of legitimacy would not systematically be viewed as illegitimate.

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?

AMAFI's view is that requiring clients' express consent to pre-hedging on a systematic basis is not feasible in the context of electronic and competitive RFQs.

Current best practices are the following:
- General disclosure on pre-hedging practices in the terms of business
- Ad hoc specific disclosure in cases where deemed necessary.

Such practices should be viewed as sufficient in a context where:
- a broad majority of clients for such transactions are well informed institutionals or professionals,
- obtaining express consent from clients is not compatible with the pace required for such transactions,
- Thanks to the general disclosure, clients have the choice to express their disagreement so that the agreement on the transaction can also be read as a tacit agreement on the pre-hedging strategy,
- time is of the essence for the proper conclusion of such transactions.

Building on such existing practices, AMAFI is of the view that some flexibility should be afforded to ISPs in the way they inform their clients depending on their appreciation of the sensitivity of the potential transaction and the type of clients or counterparty they are about to deal with.
In particular, a tacit consent procedure should be deemed sufficient for transactions concluded with eligible counterparties.

As for the second question, in AMAFI's view, an adequate disclosure on pre-hedging should indeed ground a presumption of legitimacy of the liquidity provider's behaviour. However, such presumption should not amount to an irrebuttable presumption since a market abuse could possibly occur after providing information to clients. Conversely, no presumption of illegitimacy should be drawn from the lack of such disclosure.

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?

To AMAFI, this question is extremely difficult to answer except in some very specific cases as the one where the LP does not intend to answer the client's RFQ, which again should not be viewed as legitimate pre-hedging practices.

Whereas pre-hedging practices may have an impact on market prices, it does not mean that the price obtained by the client from its LP would have been better without pre-hedging. Conversely, it can be argued that the quotes that would be provided by liquidity providers in the absence of any visibility on their hedging conditions is likely to encompass a significant markup or markdown aimed to cover that risk. Therefore, in a such case, the bid/offer spreads are likely to be broader, to the detriment of the clients, than it would be with pre-hedging transactions.

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.

Whereas these items are not specifically caught by LPs' current day to day record keeping processes, such elements should be possible to reconstruct on an ex-post basis, based on records stemming from MiFID and MAR requirements.
Therefore, to AMAFI, no extra record keeping requirements should be adopted for pre-hedging transactions.

- *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.

AMAFI's view is that liquidity in itself is not a sufficient criterion to appreciate the legitimacy of pre-hedging transactions. In particular AMAFI strongly disagrees with the view of some respondents to ESMA's consultation reflected under paragraph 44 that pre-hedging does not seem to be justified for liquid financial instruments. The strategy by a firm to manage its risks cannot be dependent upon the liquidity of the underlying instrument to a transaction, with no consideration to other factors, such as the size of the transaction, the market conditions at the time of the transaction and their possible evolution (transaction being negotiated before a significant announcement for instance).
As stated in our answer to Q6, such criterion must be appreciated on a case-by-case basis alongside with many others like: transaction size, type of financial instruments, relevant news on the market…Such factors can evolve rapidly and therefore must be assessed on a case-by-case basis.

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?

Pre hedging transactions occur most of the time in relation to transactions with eligible counterparties but can also happen in the course of transactions with professional clients, and exceptionally with retail clients. Eligible counterparties and professional clients are familiar with this practice.

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.

Such practices are indeed typically taken into account by investment firms when defining their processes and procedures aiming to prevent COIs from damaging the interests of their clients as required per MIFID regime.

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?

As stated under answer to Q14, to AMAFI, current practices are the followings:
- General disclosure on pre-hedging practices in the terms of business
- Ad hoc specific disclosure where deemed necessary.

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?

To AMAFI, such practice is very rare among AMAFI's members.

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?

No specific records are kept for such transactions that are registered like any other transaction concluded by LPs on own account.
That said, it should be possible, on an ex-post basis, to identify the corresponding transactions and reconstitute the conditions under which they were concluded.

However, AMAFI would like to point out that pre hedging a future transaction (as hedging a transaction) is not necessarily done through one-for-one transactions, as inventory risks are also managed more globally, considering the resulting positions of different desks.

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

No.

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

No.