ISDA Safe, Efficient Markets

FIA

Final FIA/ISDA response to ESMA call for evidence on pre-hedging

30 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.

ISDA and FIA welcome the opportunity to respond to ESMA's call for evidence on pre-hedging. In addition to presenting the view of our members in our response, we also support the response submitted by AFME.

Our members consider the proposed definition to be too general and able to capture a wide range of risk management activities.

Overall, our members note that pre-hedging is a practice frequently used in financial markets globally as a risk management tool and that it is used to benefit clients and provide vital market making activities. We highlight that the practice of pre-hedging has been considered at length and described in codes such as Principle 11 of the Global FX Code and the FMSB Standard for Large Trades which sets out the principals by which firms should undertake legitimate pre-hedging activity. In addition, the metals industry developed the Precious Metals Code. All of the standards and codes were devised with significant input from market participants and regulators.

A number of regulators have recognised of these codes, which is an efficient and effective way of embedding these practices in the market, in a way which incorporates industry insights and ensures international alignment.

The GFXC and the FMSB standards provide a strong basis for firms to approach pre-hedging on, and balance firm principles with the flexibility required to be applicable across a range of markets and to account for the manifold and multivariant situations in which pre-hedging could be required. ESMA should not seek to put in place prescriptive requirements as these would constrain firms' abilities to manage their risk, which is ultimately detrimental to firms' ability to serve clients.

Our members strongly support that existing codes are sufficiently broad, not overly prescriptive and leave room to adapt them to various markets and trading strategies. We strongly recommend taking these existing codes into account and to identify if there are any gaps that would benefit from additional ESMA guidance on pre-hedging.

If requirements around pre-hedging become too restrictive, then firms will stop engaging in this activity; this could lead to markets being exited, creating less competition and client choice; or firms ceasing pre-hedging which could leave clients with greater exposure to market moves, ultimately a worse outcome for clients as well. Importantly, if regulators consider a RFQ as an inside information and apply rules preventing firms from executing other trades in such instrument until it is clear that the RFQ is actually executed and public, it will create a severe visibility problem for firms. For example, Client A asks Bank B, C and D for a quote. Bank B would not be able to know whether the client executed the trade with Bank C or D or whether the client opted for no execution. If firms are

not able to execute other trades in the same instrument unless clarity arises, firms may not be willing to offer quotes to other firms.

Furthermore, as the majority of RFQs are unsolicited, the treatment of RFQs as inside information could lead to pushing firms out of the market for an indeterminate period of time – this would reduce liquidity, and if it affected market makers, could severely disrupt markets.

ESMA notes that pre-hedging should be conducted entirely for the benefit of the client, but we would like to point out that measuring this benefit is complex. Benefits cannot be purely judged on a trade-level basis, this has to be assessed on a portfolio basis.

This call for evidence seems to be focussed on trade-level pre-hedging, in practice a lot of pre-hedging happens at a portfolio level, e.g. inventory risk management at portfolio level. We think that this is an efficient practice not related to insider information.

We would also like to point out that no abusive behaviours are intrinsic to pre-hedging and that all market participants have a duty to abide by MAR for which there already surveillance controls in place.

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?

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'?

We support the guidance set out in the GFXC on practices related to last look which aim to mitigate abuse risks related to 'last look' protocols.

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

Our members are supportive of the arguments made in favour of pre-hedging.

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

In addition to presenting the view of our members in our response, we also support the response to this Question submitted by AFME.

Our members are concerned that it would be very challenging to fulfil the condition that the RFQ is precise. Our members generally do not consider that the information contained within an RFQ would be sufficiently precise and that Art. 7 (1) (d) of MAR should apply.

Should RFQs generally be considered inside information, market participants may no longer able to provide quotes on request. An RFQ is made early in the process of a transaction, whereas an order takes place later and is more likely to be considered precise: we are therefore of the view that RFQs would not fall within the definition of inside information contained in MAR. We think that this is the right result, given the fact that if RFQs were considered 'inside information' it would no longer be possible for market participants to provide quotes on request. If market participants were no longer able to respond to RFQs, markets would need to move to centralised order books, which would not work for all markets, especially those characterised by lower liquidity and more customisation such as derivatives markets.

Our members further note that RFQs are at the heart of core market making activities and that these activities are usually outside of the scope of market manipulation considerations and point to the text within MAR 1.3 which describes examples of front – running behaviour and how these differ to the legitimate behaviours of market makers.

Finally, if RFQs were to be considered inside information, the receipt of an RFQ could preclude a trader or desk from being able to operate in a given instrument or market. Given that RFQs are often unsolicited, this could pose material risk to the operation of markets, especially for RFQs submitted to market makers.

> 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 note that whilst the size of the quote, scope of the instrument and the liquidity profile will have an impact on the price of a financial instrument, the creation of an exhaustive list of criteria by ESMA would be problematic. Further, the proposal does not consider the significant number of factors and elements at play or the difficulty of gathering relevant data on e.g. liquidity or the size of the transaction. In practice identifying a set of pre-defined criteria to determine the impact on prices would be extremely complex and would likely have to differ on an instrument-by-instrument basis.

> 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?

Defining “objective circumstances” on which to conclude that a transaction will not be awarded would be extremely difficult, as there are many possible factors at work which may play into a client’s decision on whether to award a transaction to a specific liquidity provider.

In the example given, a quote which is far from the observable market spread of a sufficient size may be accepted by a client. Distance between quote and market is not a reliable indicator, especially for market makers as by definition the market makers’ quotes define the market position.

> 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?

In general, we think that indicators, in particular binary indicators, could be problematic due to the variability of circumstances in which pre-hedging could be legitimate. An unclear set of indicators could then create unnecessary uncertainty.

Pre-hedging should be conducted for the benefit of the client, however quantifying this benefit can be extremely difficult. The benefit to the client may be in the form of narrower spreads, or be manifest in the ability of the liquidity provider to be able to offer a quote or a transaction at all. Further, it is entirely possible for the market to move against the client between the pre-hedge and the conclusion of a transaction entirely due to natural market movement, with no malfeasance.

> 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?

> 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 do not think it would be feasible to for a dealer to assume whether they will conclude a given transaction. They would need to know that they will 'win' a client's RFQ and whether the client decides to execute.

At the minimum, for low-touch / high volume markets such as flow businesses, this level of requirement could be a substantial impediment to timely execution for clients and the management of risk, and would add substantial operational friction to the execution of client business. This could be particularly pronounced for market makers.

> 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.

There are potential risks with the use of indicators to delineate between legitimate pre-hedging and illegitimate behaviour. The wide variety of relevant factors which would need to be considered, both for the market itself and the position of the firm conducting the pre-hedging, would make such an exercise extremely complex and liable to unintended consequences.

In terms of liquidity specifically, the definition of a given market as "Liquid" or not presents challenges in itself. The liquidity of a given market can vary significantly on a day-to-day basis, and even intraday. It is also subject to both market and world events.

Finally, pre-hedging can be just as legitimate in liquid markets as in illiquid ones – restricting firms' ability to risk manage based on the liquidity of a given market may even negatively impact the liquidity of the market itself.

Our members believe that the legitimacy of a pre-hedging transaction can only be assessed based on an holistic case-by-case basis,. The GFXC recognised that the impact of liquidity can vary and our members would not support making this a mandatory indicator.

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?

Our members advise that they make general disclosures to their clients in their terms of business that they may undertake pre-hedging activities and consider clients consent to "pre-hedging" unless they explicitly opt out.

We further note that it would be very difficult to obtain consent in flow markets on a case by case basis in the context of electronic and competitive RFQs for a number of reasons including the slowing of markets and very large system build outs that would bring no benefit to the client. Additionally, whilst obtaining consent from the client to pre-hedge would be an indicator of adherence to the principals within the GFXC and FMSB Large Trades paper with respect to transparency, obtaining consent from the client does not make the pre-hedging activity itself legitimate and MAR compliant.

There is a danger that prescriptive requirements for case-by-case consent could equate to a 'tick box exercise' which would add substantial operational difficulty, without providing meaningful benefits to firms or clients. Restrictions on firms' ability to pre-hedge would likely have significant impact on the liquidity available to clients, their costs and greater volatility in markets.

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?

While our members agree that a client could be given a choice between quotes with/without pre-hedging in certain markets, this would not be feasible in all markets and thus should not be a mandatory requirement but remain in the discretion of the RFQ provider.

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?

Our members do not currently flag transactions that are subject to pre-hedging activities, however they do comply with record and retention obligations for orders and transactions (under MiFID) which enable them to reconstruct trades.

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