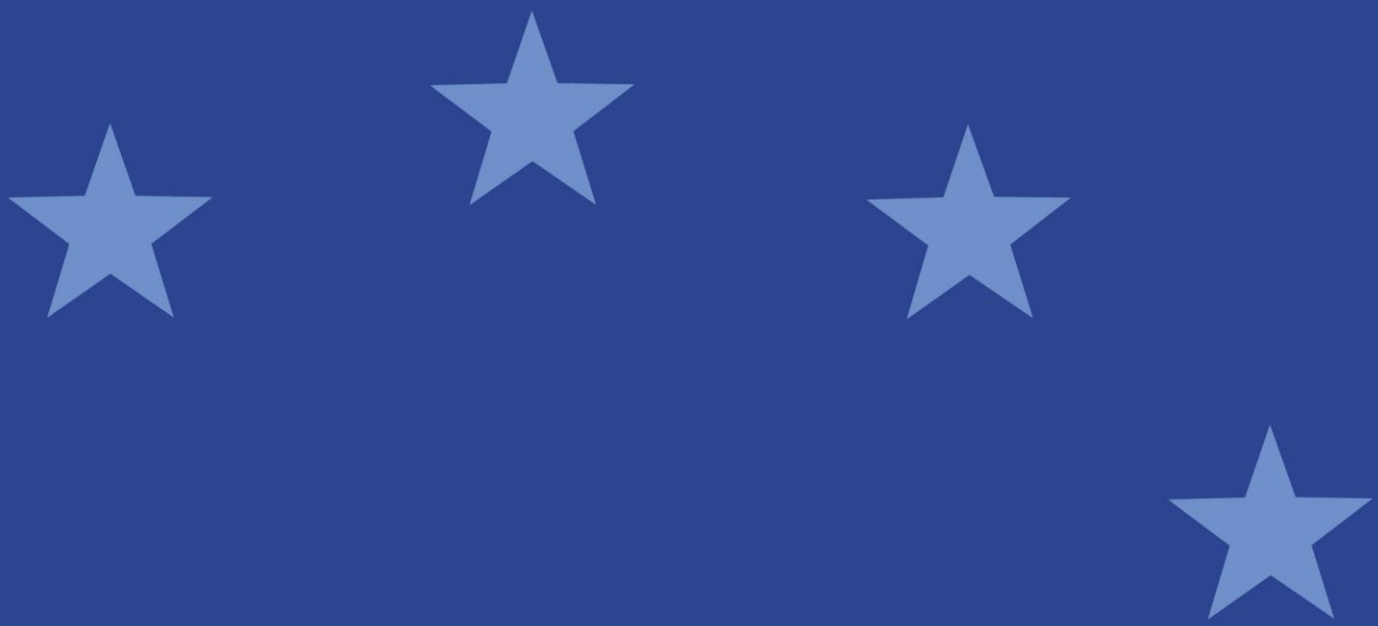
esma European Securities and Markets Authority

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	Associazione Intermediari Mercati Finanziari - Assosim
Activity	Investment Services
Are you representing an association?	☒
Country/Region	Italy

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>
Whether or not case (i) and case (ii) amount to pre-hedging is a matter of definition. As long as we define pre-hedging as any transaction carried out on own account with the purpose of hedging inventory risk in an anticipatory manner in presence of a potential incoming transaction, both case (i) and case (ii) should fall within this heading, and in our view both should be considered MAR-compliant transactions per se. As a matter of fact, pre-hedging (likewise hedging) could hardly amount to harmful behaviour. On the contrary, there is plenty of evidence that pre-hedging is a necessary precondition for market participants to provide liquidity in the market, reduce volatility, lower costs and thereby contribut to better trading opportunities for the benefit of investors, issueers and the economy at large. In its 2013 Guidelines on the *Exemption for market making activities and primary market operations under Regulation*
(EU) 236/2012 of the European Parliament and the Council on short selling and certain aspects of Credit Default ESMA itself has recognised that "*anticipated hedging is necessary for the performance of actual market making activities and is not carried out on other grounds, such as speculative*".
Accordingly, we do not see any benefit in issuing guidance on what should be considered MAR-compliant in terms of pre-hedging. To the benefit of market operators (as well as competent authorities) neither we see any advantage in drawing a line between pre-hedging, on the one side, and front running, on the other side. In fact, by no means should an activity whatsoever carried out by an intermediary for the purpose of hedging its inventory risk in anticipation of, or following the receipt of a customer order be considered in breach of MAR requirements. As we just said, this would be the case in the event of both a transaction carried out ahead of the acceptance of a quote provided by the intermediary in the context of an RFQ (case i), and a transaction carried out ahead of a pending order (case ii). In principle, only transactions carried out ahead of a client "firm" order could be considered as front running; still, this would not in turn imply that they amount to insider trading per se.
<ESMA_QUESTION_PHDG_1>

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

<ESMA_QUESTION_PHDG_2>
We believe that the definition provided in the CFE (wich includes under the heading of pre-hedging any transaction carried out for the purpose of hedging inventory risk in an anticipatory manner in presence of a potential incoming transaction) is broad enough and does not require the inclusion of other market practices.
<ESMA_QUESTION_PHDG_2>

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

<ESMA_QUESTION_PHDG_3>
We believe that distinguishing between "traditional hedging" and pre-hedging is a usless exercise in that both should be held as legitimate mitigation activities (see our answer to Q1).

<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>
We believe that last look options provide market intermediaries with the opportunity to serve their clients on better price terms (or improve the bid/offer provided to the client) and even is a necessary precondition to provide quotes in difficult market conditions. As such, this option should not be prohibited, nor should its legitimacy be subject to any conditions.
<ESMA_QUESTION_PHDG_4>

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

<ESMA_QUESTION_PHDG_5>
We fully agree with all of the advantages of pre-hedging outlined in paragraphs 24 to 28. In addition to these, a further advantage of recognising the legitimacy of pre-hedging would be to allow more liquidity providers to enter the market and enable the execution of orders (especially large orders) that would otherwise be unable to receive a price or liquidity. On the contrary, if pre-hedging were banned or if its legitimacy were subject to burdensome conditions, only global brokers would be able to take the risk of quoting prices in the market, to the detriment of competition. Given the interest of global brokers in providing liquidity exclusively on highly-liquid large caps, any restriction on pre-hedging and the consequent exit of local brokers from the market would lead to a reduction in liquidity and thus an increase in volatility and cost of capital for less-liquid SMEs. Moreover, we fully support point 46 of the CFE namely that pre-hedging transactions in illiquid instruments appear to have a stronger risk management rationale because the intervention of the LP might be necessary to facilitate trading and to sustain liquidity for these instruments.
<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>
It is true that the larger a foreseeable transaction is, the more likely it is to have an effect on market prices. Still, RFQ markets are specifically designed to reduce the effect of large orders on the market. In this context, the possibility recognised in all jurisdictions for intermediaries to manage (to pre-hedge) the risk they take in providing quotes against an RFQ is also intended to further reduce the impact of large orders or complex orders on market prices. Namely, the impact of these foreseeable transactions would be higher in the event the intermedary were not allowed to pre-hedge its risk.
<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>
By definition, the higher the probability for an LP to discover the trading intentions of its client within the contest of an RFM, the more precise the relevat information would be. Once again, the higher the ability of the LP to pre-hedge the impact of a susequent order, the smaller the impact of its execution in the market and, as a consequence, the better the quality of the execution the LP could offer to the client in terms of price conditions and costs. In any event, by no means could news flow be considered precise information.
<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>
In principle, the main factors of a foreseeable order which are normally taken into account to asses its impact on the market price are its size and the liquidity as well as the market flows of the relevant financial instrument. It is up to the LP to carefully consider all these factors when hedging its inventory risk to offer its best quotes to the client and thus win the trade.
<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>
We agree that GFXC might provide useful guidance to asses legitimacy of pre-hedging on the FX market. Additional cases of risk management rational might be considered as regards different markets.
<ESMA_QUESTION_PHDG_9>

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

<ESMA_QUESTION_PHDG_10>
We believe that it would not be possible to identify abstract example of practice without a rationala. Indeed, such an exercise should be run on a case by case basis.
<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>
We believe that a market participant can never be absolutely certain that he will not be awarded the transaction. Accordingly, the legitimacy of pre-hedging carried out under these circumstances should be assessed on a case-by-case basis.
<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>
As a general rule, no financial instruments should be banned for the purpose of pre-hedging; none can be excluded a priori.
<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>
In line with our answer to Q1, pre-hedging should be considered a legitimate activity in itself. Accordingly it is no useful to identify any indicator of any kind.
<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>
Seee our answer to Q13.
<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>
We believe that the sole risk that pre-hedging could not bring any benefit to the client is not sufficient to qualify this activity as in breach of the MAR. Once again, any assessment should be conducted on a case by case basis.
<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>
Due to the fact that the market in general benefits from pre hedging activities carried out by LPs, it would be extremely burdensome and not proportionate to require them to keep evidence of all these circumstances. As a matter of law, in the event of an alleged breach, it should be up to the market authorities/criminal prosecutors to provide evidence of all the circumstances which account for a breach of the relevant provisions.
<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>
We believe that pre-hedging is in itself legitimate behaviour. As already mentioned, it benefits the client, the market and the issuer. We believe that the lower the liquidity of a financial instrument, the greater its benefits. However, the mere fact that investors also direct their orders on liquid financial instruments to RFQ markets is clear evidence that a market impact on these instruments cannot be excluded.
<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>
In our experience pre hedging activity is mainly correlated to wholesale markets though it can also involve professional clients large-in-scale orders.
<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>
Our members refer that under MiFID 2 they have had to delvelop procedures to addres any possible risk of COI, including COI arising when executing on own account their clients' orders.
<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>
Based on information provided to us by our members, there is not a standard practice that covers all trading models. Disclosure may occur in a variety of ways, e.g. within the contract, in the terms of business, during the onboarding process and is a more common practice for voice trading in large-in-scale orders.
<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>
According to our members there is not any common practice in this regard.
<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>
We believe that record-keeping requirements of MAR and MiFID already provide a sufficiently robust set of information to allow the internal control funcions to monitor compliance with the relevat regulations in real time and competent authorities to audit the performance of pre-hedging activities.
<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>
TYPE YOUR TEXT HERE
<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>
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<ESMA_QUESTION_PHDG_24>