ASSOCIATION FRANÇAISE DES MARCHÉS FINANCIERS

FINANCIAL MARKET PROFESSIONALS

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ESMA Report on the call for evidence on pre-hedging

AMAFI's observations

Pre-hedging is a practice that takes place when investment firms hedge, at least partially, their inventory risk in anticipation of a potential client order that is expected. In certain circumstances, it may raise concerns in terms of insider dealing, as the investment firm may be considered to have used inside information about the incoming order to trade against the client.

In the context of the MAR Review, ESMA began to take an interest in pre-hedging practices, as some NCAs reported concerns from market participants on pre-hedging behaviour. Considering that the issue merited further analysis, the Authority launched a Call for Evidence (CfE) in July 2022, to gather stakeholders' views on this practice.

Following ESMA's publication of its Report on the call for evidence on pre-hedging (to which the Association contributed through *AMAFI / 22-67*), AMAFI would like to highlight several points in view of further clarification[1] by ESMA.

Pre-hedging practices are essential to the good functioning of financial markets, as they serve to provide liquidity while allowing investment services providers (ISPs) to manage their risk and thus offer the most attractive prices. They also serve the interest of clients because without the possibility to pre-hedge, many ISPs would generally be unable to answer clients' RFQs, as answering them would lead to too much risk taking. If they were to answer such RFQs, the spread offered would have to be widened to the detriment of clients.

This practice thus ultimately serves the interests of issuers and investors, as it allows for better quotes and the very existence of those. If such practices were to be banned, the risk is high that the market liquidity would be significantly reduced.

Therefore, AMAFI, while acknowledging that such practices need to be thoroughly monitored to prevent market abuse, finds it of the utmost importance that **pre-hedging practices are not systematically viewed as insider dealing.**

[1] See the paragraph entitled "next step" in the "executive summary" of the report: "*Given the feedback received and the issues raised, ESMA believes that **global regulatory principles** applicable to pre-hedging could be beneficial in fostering a common regulatory approach to this practice. Those principles could serve as basis for the development of any **future ESMA guidance**.*"

THE DEFINITION OF PRE-HEDGING SHOULD BE PROPERLY CALIBRATED

We understand that ESMA is contemplating providing a definition of pre-hedging in its potential future guidelines and has consulted on a possible definition on which AMAFI has the following comments:

- **Clarifications 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 paramount importance that a liquidity provider (LP) who receives an RFQ from a client on a specific financial instrument should not be prevented from conducting its usual inventory management on the same financial instrument. Otherwise, it would not be able to fulfil its function of continuously providing two-way quotes on this financial instrument and thus liquidity. In that respect, it is important to note that the pre-hedging of a future transaction, like the hedging of a transaction, is not necessarily done through one-for-one transactions, as inventory risks can also be managed globally considering the resulting positions of different desks. An ISP can legitimately conclude transactions for global inventory hedging purposes and such transactions should not be caught by pre-hedging potential rules or guidance.

  Therefore, the definition adopted should reflect that pre-hedging transactions are not all the transactions occurring after a certain point in time (i.e after having received a client's RFQ), even if concluded for risk monitoring purposes. Only those **undertaken to mitigate an inventory risk stemming from a possible transaction should be considered as pre-hedging transactions.**

  AMAFI is concerned that the ESMA Report does not seem to take such point into account.

- **Pre-hedging is not hedging:** the case (ii) in § 9 of 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*".

  To AMAFI, a distinction should be made between:
  - situations where the LP has the certainty to deal and only the price is to be determined: in such cases, the risk is known and the situation does not correspond to pre-hedging but hedging.
  - situations where the size of the transaction is not known, which could amount to pre-hedging because the risk cannot yet be determined.

  To us, the distinction between hedging and pre-hedging should be based on the timing of the hedging transactions compared to the timing of the agreement between the parties to enter into the transaction: if the agreement with the client is concluded before the hedging transactions are carried out, such transactions are hedging transactions. Pre-hedging transactions should be limited to transactions that occur before the agreement with the client.

  AMAFI is concerned that such distinction would not be taken into account (see § 26 where ESMA concludes that "*the proposed definition of pre-hedging could be used as a starting point for further guidance.")*.

PRE-HEDGING AND MAR

A consistent approach on pre-hedging practices should be sought at a global level to ensure a level playing field between EU banks and third-country competitors.

It is essential that RFQs should generally not be viewed as embedding inside information because, by their very nature and unlike client orders, they are not sufficiently precise, and uncertainty exists as to the likelihood of execution. Consequently, pre-hedging transactions should generally not be considered as insider dealing but should require a case-by-case analysis.

It is extremely important that the legitimacy of the pre-hedging practice, which may entail a risk of misuse of inside information, is assessed with sufficient scrutiny. Accordingly, if, as suggested in the CFE, ESMA was to publish a list of criteria for legitimacy or illegitimacy, it seems essential that such a list should be presented as non-exhaustive and illustrative, leaving room for a case-by-case approach. Compliance with the list should not be considered as sufficient to conclude on the legitimacy or illegitimacy of the transaction, meaning in particular that a transaction that does not meet all the criteria would not systematically be viewed as illegitimate.

CLIENT CONSENT

In AMAFI's view, adequate disclosure of pre-hedging to clients, as suggested by ESMA in its CfE, could ground a presumption of legitimacy of the liquidity provider's behaviour. However, such a presumption should not amount to an irrebuttable presumption since market abuse could potentially occur after providing information to clients. Conversely, no presumption of illegitimacy should be drawn from the lack of such disclosure.

However, it is not feasible to systematically require clients' express consent to pre-hedging in the context of electronic and competitive RFQs where time is of the essence.

This is the reason why the best practices are currently the following:

- General disclosure to clients on pre-hedging practices in the terms of business/terms of dealing,
- Ad hoc specific disclosures when deemed necessary, such as when there is risk of a significant effect on the prices.

Such practices should be viewed as sufficient in a context where:

- the vast majority of clients for such transactions are well informed institutional or professional clients,
- obtaining express consent from clients is incompatible with the speed required for such transactions,
- general disclosure gives clients the opportunity to express their disagreement, so that consent to the transaction embeds the consent to the pre-hedging strategy provided through the terms of business.

Building on these current practices, AMAFI believes that ISPs should be given some flexibility in the way they inform their clients, depending on their assessment of the sensitivity of the potential transaction and the type of client or counterparty involved.

In particular, a tacit consent should be deemed sufficient for transactions concluded with eligible counterparties.

AMAFI considers it essential that the type of market (electronic or not) and the client specificities are taken into account when deciding whether to inform clients of potential pre-hedging.