PRE-HEDGING

IOSCO'S CONSULTATION

AMAFI's answer

AMAFI is the trade association representing financial markets' participants of the sell-side industry located in France. It has a wide and diverse membership of more than 170 global and local institutions notably investment firms, credit institutions, broker-dealers, exchanges and private banks. They operate in all market segments, such as equities, bonds and derivatives including commodities derivatives. AMAFI represents and supports its members at national, European and international levels, from the drafting of the legislation to its implementation. Through our work, we seek to promote a regulatory framework that enables the development of sound, efficient and competitive capital markets for the benefit of investors, businesses and the economy in general.

AMAFI welcomes the opportunity to respond to IOSCO's Consultation on pre-hedging.

I. ON CHAPTER 5 ON THE DEFINITION OF PRE-HEDGING

QUESTION 1 : DO YOU AGREE THAT THIS IS THE CORRECT DEFINITION OF PRE-HEDGING? IF NOT, HOW WOULD YOU DEFINE PRE-HEDGING?

We have several observations on the proposed definition:

- The term "client" should be replaced by "counterparty" as, in many instances, pre-hedging transactions are concluded with third parties to whom no service is provided and are therefore not clients.
- We struggle to see how the reference to "*applicable laws governing frontrunning, trading on material non-public information/insider dealing, and/or manipulative trading"* brings clarity to the definition. As noticed by IOSCO in its consultation report[1], "*pre-hedging entails market abuse in different jurisdictions"* and "*the proposed recommendations should be read first and foremost as ancillary to each jurisdiction's existing regulations, including market abuse regulations*". Our reading of this statement is that, as all other transactions, pre-hedging transactions are subject to all applicable laws. Therefore, we do not consider that this should be part of the definition. .
- In line with the definition under the FX Global Code and the ESMA definition, we see it as essential that the criterion that such transactions should be reasonably designed for the counterparty's benefit be included in the definition in order to ascertain their legitimacy. Due to the difficulty to measure such benefit brought by pre-hedging transactions, the drafting

[1] Chapter 1 Introduction Scope and Approach, p. 8.

should concentrate on the intention not to disadvantage the counterparty and not on the outcome itself. To prevent the commission of potential market abuses, it is also important to incorporate in the definition the intention not to disrupt the market.

- Under (ii), the counterparty's transactions triggering such pre-hedging transactions should be sufficiently likely within a short timeframe. Therefore, we suggest replacing the terms "an *anticipated client transaction*" by "a *reasonably expected near-term transaction by a counterparty*".
- Additionally, the definition should recognise that pre-hedging may apply to multiple transactions.
- Finally, contrary to what is mentioned in foot note 25, we do not see why borrowing or lending transactions could not be in scope of pre-hedging since dealers concluding such transactions may also pre hedge their risk related to counterparties' likely transactions;

We suggest amending the definition as follows:

"trading[25] undertaken by a dealer, **~~in compliance with applicable laws and rules, including those governing frontrunning, trading on material non-public information/insider dealing, and/or manipulative trading~~** where:
(i) the dealer is dealing on its own account in a principal capacity;
(ii) the trades are executed after the receipt of information about **a reasonably expected near-term transaction or transactions by a counterparty** **~~an anticipated client transaction~~** and before the **counterparty** **~~client~~** (or an intermediary on the **counterparty** **~~client~~**'s behalf) has agreed on the terms of the transaction and/or irrevocably accepted an executable quote; **~~and~~**
(iii) the trades are executed to manage the risk related to the anticipated **counterparty** **~~client~~** transaction **or transactions and**
(iv) the trades are executed with the intention not to disadvantage the counterparty nor to disrupt the market."

Foot note 25: "Trading" in this context would not cover **~~borrowing, lending,~~** clearing, or correction of trading errors."

II. On chapter 6 on recommendations for determining when pre-hedging is acceptable

Question 2: Do you agree with the proposed types of genuine risk management? Are there other factors not mentioned in this report that should be considered for determining genuine risk management?

We agree that the proposed criteria to determine the "*genuine risk management purpose*"[2] are relevant.

However, we are of the view that different risk management considerations may also be relevant and that different strategies may apply, depending on asset class, business sector, risk profile, risk appetite…

Rather than setting a limitative list of legitimate risk management criteria, it would therefore be more relevant that dealers are requested to demonstrate the rationale to pre-hedge as well as the intention not to disadvantage the counterparty nor disrupt the market.

If the list was maintained, it should not be presented as being exhaustive.

Question 3: Do you agree that pre-hedging of wholesale transactions should be acceptable where there is sufficient liquidity in the underlying instrument/s to hedge after the trade is agreed to? Please elaborate.

Yes. However, while being definitely relevant, liquidity should not be the sole criterion to determine the pre-hedging strategy. To us, pre-hedging transactions should be possible whatever the liquidity of the financial instruments, for the following reasons:

- Liquidity is not equal for all market participants on OTC markets: the willingness to trade for a counterparty largely depends on the risk perceived by the market participant. The liquidity available to one market participant also depends on their assessment of the risk taken towards the different available counterparties.
- Liquidity can quickly vary, and even so-called liquid financial instruments may go through volatile market conditions.

Moreover, liquidity is a data that is difficult to evidence on an ex-post basis. The fact that such liquidity appears to be sufficient after the trade is agreed should not in itself be deemed sufficient to evidence that there was sufficient liquidity at the time when the pre-hedging transactions were undertaken.

Finally, other relevant criteria, besides liquidity, should be taken into account when making the decision to pre-hedge, such as market size, volatility or market events.

[2] (a) having a legitimate expectation of a client transaction; (b) available liquidity; (c) market conditions; and (d) the extent of pre-hedging that is required (i.e., proportionality).

Question 4: Can there be a genuine need to pre-hedge small trade sizes in liquid markets for risk management purposes?

As previously stated, liquidity is a volatile notion, and some financial instruments could be viewed as liquid, based on their average day-to-day trading figures, and nonetheless experience some unusual occasional liquidity gaps. Moreover, as stated in our answer to the previous question, liquidity is not equal for all market participants, especially on OTC markets.

Additionally, "small trades" is a concept that is very difficult to define across all jurisdictions and assets classes and pre-hedging small trades can be necessary.

Therefore, pre-hedging should be possible even for small trade sizes in liquid markets and should be left to the discretion of the dealer.

Question 5: Where a dealer holds inventory should they first consider using such inventory to offset any risk connected with an anticipated client transaction or should they be allowed to pre-hedge?

As part of market making, risk management in the form of building an inventory can be undertaken (i) in anticipation of particular client transactions, (ii) to manage the risk subsequent to client transactions or to a change in market conditions (e.g. observed market conditions, management of risk limits) or (iii) to position the book ahead of foreseen client activity without precise information on an anticipated transaction.

Therefore, dealers should not be mandated to use inventory that may be used for (i), (ii) or (iii) whilst using/ not using the existing inventory may be considered as part of the pre-hedging decision.

Question 6: What factors should dealers consider in determining the size of pre hedging an anticipated client transaction (e.g., size, instrument type, quotation environment)? Should there be an upper limit for the pre hedging amount? If so, what type of limits (e.g., percentage based, Greek based) are appropriate for consideration? Please elaborate your response in relation to bilateral OTC transactions and for competitive RFQ systems including those in electronic platforms.

As rightly pointed out by IOSCO, pre-hedging transactions may have an impact on the price of the financial instrument concerned. In that respect, the CR states that *"IOSCO believes that pre-hedging should not move prices against the client's interest and should be used with the intention to benefit a client".* However, determining the amount to pre-hedge is definitely a delicate exercise, very much dependent on the circumstances of the case at the time of the decision making, as asset class characteristics, market dynamics/liquidity, and risk management needs might impact any decision related to how much a liquidity provider chooses to pre-hedge. This should be left to the dealer's case by case assessment.

Therefore, the only absolute limit that could be set on the size of the pre-hedging is 100% of the nominal of anticipated transactions as long as pre-hedging transactions are intended not to disturb the market and to benefit the counterparty.

QUESTION 7: DO YOU AGREE WITH THE CONCEPT OF CLIENT BENEFIT DESCRIBED ABOVE?

We think it is essential to acknowledge that pre-hedging takes place for dealer's risk management purposes (e.g. to manage exposures and limits) and aims at facilitating transactions with counterparties (some of which may be clients). Therefore, they will not necessarily be to the sole benefit of the counterparty.

Moreover, the benefit to the counterparty can take several different forms other than price improvement and are hardly measurable, including:

- the mere ability to trade: pre-hedging is sometimes a sine qua non condition for the dealer to make a quote,
- the speed of the transaction,
- the mitigation of market impact by using a longer period of time for hedging.

In any case, the benefit brought to counterparties may not be easy to demonstrate and may be hampered by other factors, not attached to the pre-hedging transactions made by the dealer.

Therefore, we see it as essential that the concept of counterparty's benefit be construed with respect to the intention of the dealer, not to the result, due to the difficulty to measure the specific impact of pre-hedging transactions.

Therefore, instead of using the concept of benefit, it seems more relevant to consider the absence of disadvantage for the counterparty. We therefore suggest requiring "*to intend not to disadvantage the counterparty, while mitigating the impact on the market*".

QUESTION 8: DO YOU BELIEVE THAT FINANCIAL BENEFITS DERIVED FROM PRE-HEDGING BY THE DEALER SHOULD BE SHARED WITH THE CLIENT? WHAT PROPORTION OF THE BENEFIT TO BE SHARED WITH THE CLIENT WOULD BE FAIR? PLEASE ELABORATE.

It should be at the dealers' discretion whether/how to share any financial benefit of pre-hedging with the counterparty.

As previously stated in our answer to the previous question, there may be situations where pre-hedging transactions undertaken for risk management purposes and with the intention to benefit the counterparty, will bring benefits other than in the form of a a financial benefit that can be apportioned.

Question 9: Should pre-hedging always be intended to achieve a positive benefit for the client or is it enough that a dealer pre-hedges for its own risk management and does not detrimentally affect the client?

Pre-hedging should be undertaken for risk management purposes, with the intention of benefiting the counterparty. However, this does not guarantee in practice that the pre-hedging transactions will eventually benefit the counterparty. Therefore, there should be no requirement for dealers to prove, on an ex-post basis, that their trades brought any benefit to counterparties. The focus should be on the initial intention not to disadvantage the counterparty

Question 10: Should dealers be able to demonstrate the actions they took to minimise the market impact of their pre-hedging trading? In the event of not entering the anticipated client transaction, are there any considerations for the dealer to minimise market impact and maintain market integrity prior to unwinding any pre-hedging position?

Pre-hedging activities should always be undertaken with the aim of limiting market impact.

However, demonstrating the "*actions taken… to minimise the market impact*" is necessarily subjective, as the counterfactual (i.e. how the market would have behaved without pre-hedging) cannot be established with certainty. Therefore, the focus for IOSCO should be on firms having the right general policies and procedures in place rather than on setting specific provisions that will result in documentation requirements that cannot be abided by with legal certainty.

In the EU, MiFID II sets the overarching principle for an investment firm to *"act honestly, fairly and professionally in accordance with the best interests of its clients" (MiFID, Art. 24.1).* Moreover, Market Abuse Regulation aims to foster "*an integrated, efficient and transparent financial market*"[3] as well as a "*smooth functioning*"[4] of such market through a number of measures such as, among others the prohibition of market manipulation and insider dealing and the prevention and detection of market abuse. These two texts require dealers to put in place processes and procedures aiming to minimise market impact. Therefore, there is no need for specific pre-hedging procedures since such activity will necessarily fall under the dealer's general procedures.

[3] Recital 2 of Market Abuse regulation
[4] Recital 2 of Market Abuse regulation

ASSOCIATION FRANÇAISE DES MARCHÉS FINANCIERS

III. Chapter 7. Management of conduct risk from pre-hedging

Question 11: Do you agree with this recommendation on appropriate policies and procedures for pre-hedging? If not, please elaborate.

This recommendation is consistent with current requirements in the EU stemming from the Market Abuse Regulation and MiFIDII and applying to all activities. However, it is inappropriate for firms to have dedicated functions installed solely for the purpose of pre-hedging transactions. According to laws and rules applicable for the purpose of market integrity and client interest, firms already have in place a framework that is compliant with these requirements, which has to be continuously monitored.

Question 12: What type of disclosure would be most effective for clients? Why?

Ex ante disclosure seems to be the best way to inform counterparties and clients as it provides them with the possibility to disagree.

However, such disclosure should not have to be transaction by transaction. For example, itis not always possible, especially in electronic markets where speed is of the essence. Conversely, information at the time of the onboarding seems to be the best way to proceed.

In any case, we see post trade disclosure as both hardly workable and poorly informative to clients.

Therefore, to us, ex ante disclosure should be applied in a tiered manner depending on the type of counterparty involved, the sensitivity of the potential transaction and the negociation mode (electronic or not).

In particular:

- A tacit consent through disclosure in the terms of business/terms of dealing should generally be viewed as sufficient. It should in particular be used for electronic transactions. It gives counterparties the opportunity to express their disagreement with the pre-hedging strategy described in the terms of business.
- Ad hoc specific disclosures should only be communicated where deemed necessary, for specific transactions, such as where there is risk of a significant effect on the prices, or for less sophisticated counterparties.

Question 13: Should upfront disclosure be applicable irrespective of factors such as the size and complexity of the transaction and/or other factors such as level of client sophistication? Are there any key challenges for dealers to providing pre-trade upfront disclosures?

See our answer to the previous question. We think proportionality is key here: general disclosure in the terms of business will be sufficient in cases involving sophisticated clients, vanilla transactions and electronic trading, whereas ad hoc disclosure could be required only for less sophisticated clients or specific transactions.

Question 14: What should be the minimum content of any upfront disclosure? Please differentiate between bilateral OTC transactions, competitive RFQs and pre-hedging in the context of electronic transactions.

An upfront disclosure could encompass:

- For general disclosure in the terms of business:
  - Whether the dealer intends to use pre-hedging;
  - The identification of the activities likely to be pre-hedged;
  - The possible impact for counterparties.
- For ad hoc disclosure on a specific transaction or specific transactions:
  - The intention to pre hedge the specific transaction or transactions;
  - The possible impact for counterparties.

We do not see here any necessity to distinguish between negociation modes (electronic or voice).

Question 15: Should trade-by-trade disclosure be proportional to factors such as the size and complexity of the transaction and/or other factors such as level of client sophistication? What should be the minimum content of trade-by trade disclosure? Please differentiate between bilateral OTC transactions, competitive RFQs and pre-hedging in the context of electronic transactions, in particular in electronic trading platforms.

See our answer to question 12.

Question 16. Are there any challenges or barriers to trade-by-trade disclosure in the context of competitive RFQs and in the context of electronic trading? Please elaborate.

See our answer to question 12.

We do not consider pre-trade by trade disclosures practical or meaningful in all markets/transactions. Again, this should be proportional to the market and transaction. As per FMSB: "*For transactions executed through electronic platforms, transaction-specific communications will typically not be practicable. Dealers instead implement periodic, ex ante disclosures.*"

Question 17. Would clients benefit from post-trade disclosures about the dealer's pre hedging practices in a transaction?

Providing counterparties with ex-post disclosure is hampered by the difficulty of reconstructing the state of the market without any pre-hedging taking place. Therefore, except upon the request of the counterparty, ex-post disclosure should not be provided.

Question 18: Should the nature and form of post-trade disclosure be agreed between the client and dealer at the start of their engagement on an anticipated transaction and be proportional to factors such as the size and complexity of the transaction and/or other factors such as level of client sophistication?

Post-trade disclosures should not be subject to prescriptive standards. The nature of disclosure will depend on the transaction, market, asset class and client relationship.

Question 19: Are there any barriers to post-trade disclosure? Please differentiate between bilateral OTC transactions, competitive RFQs and pre-hedging in the context of electronic transactions, in particular in electronic trading platforms.

Providing counterparties with ex-post disclosure is hampered by the difficulty of reconstructing the state of the market without any pre-hedging taking place as well as isolating transactions undertaken for pre-hedging purposes of a specific transaction and the ones undertaken to hedge the dealer's overall positions or other clients' orders.

Question 20: Do you agree that clients should have the ability to explicitly inform the dealer that they do not want pre-hedging to take place in relation to a specific transaction (or revoke explicit or implicit consent to pre-hedging)? Are there any circumstances under which the dealer would not be obliged to follow the new client instructions? If not, what are the potential issues or risks to clients of this approach? Please elaborate your response to the question for bilateral OTC transactions, for competitive RFQ systems and for those in electronic trading platforms.

Generally speaking, we agree that counterparties should have the ability to explicitly inform the dealer that they do not want pre-hedging to take place either in relation to a specific transaction or in general. In such a case, the dealer should be obliged to follow the counterparty's instructions. Clients may "opt out" and request that the dealer not engage in pre-hedging for a particular transaction; however, such request may limit the ability of the dealer to provide transaction execution at a favourable price, if at all.

However, trade-by-trade differentiated treatment may not always be available: for instance, with respect to RFQs, dealers may not be able to always provide quotes with and without pre hedging and may make the choice to provide exclusively one or the other. In our view, they should be free to do so.

Some dealers may also not want to deal with the challenging requirement to track which counterparties do not accept pre-hedging. In such a case, clients should be informed of such impossibility.

Question 21. Should dealers be required to obtain explicit prior consent to pre-hedge for certain types of transactions? Please elaborate your response to the question for bilateral OTC transactions, for competitive RFQ systems and for those in electronic trading platforms.

No. Explicit prior consent is in most cases unworkable, considering the pace of the market. It should be deemed sufficient to provide clients with upfront disclosure (either on a general or a trade-by-trade basis). Counterparties will then have the ability to disagree and choose not to trade with the dealer. In case they do trade, they would legitimately be considered as having agreed to pre-hedging.

Question 22: Should stand-alone post-trade reviews be conducted for pre-hedging? How would this improve supervision of pre-hedging activities? Could this review be also used to respond to client requests for post trade review of execution practices?

In compliance with applicable EU laws and rules (including MiFID and MAR), dealers have trade surveillance and best execution monitoring processes that are designed to capture infringement to such laws and rules. Requiring a specific monitoring for pre-hedging transactions does not appear to bring added value to this process. Liquidity providers should determine the appropriate post-trade review process consistent with their compliance and supervisory arrangements and proportional to the nature of the market and transaction type, considering a risk-based approach. As for the possibility to use this review to respond to post trade request for information from clients, we refer to our answer to Question 17.

Question 23: Do you think it is reasonable (in terms of costs and benefits) to require dealers to have internal controls to ensure differentiation between pre hedging and inventory management?

Dealers do not cease their principal market making and related hedging activity for other counterparties when they engage in pre-hedging in relation to a counterparty's likely transactions. This pre-hedging activity may be inextricably linked to others, particularly when a dealer is hedging its risk at a portfolio level. Therefore, the differentiation between pre hedging and inventory management would be impossible to make without tagging pre-hedging transactions which is not always possible: 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.

However, dealers are already subject to extensive general reporting and record keeping obligations under existing regulations (MiFID and MiFIR in the EU).

Therefore, there should be no obligation to identify and record pre-hedging trades separately. Such a requirement would be disproportionate in terms of costs and time where data on such trades is already available. It would not bring any additional benefits in terms of trades surveillance and monitoring, knowing that trades can be reconstructed on an ex-post basis.

Question 24. What level of detail would be sufficient to have adequate records of pre hedging activity to facilitate supervisory oversight, monitoring and surveillance?

Once again, we think that specifics of record keeping will depend on the nature of the market, type of transaction, activity…. As stated under the answer to the previous question, identifying pre-hedging activity may appear challenging where pre-hedging activity is not segregated or tagged. Such segregation or tagging is not practical or desirable for all situations.
However, dealers comply with record and retention obligations for orders and transactions (e.g. under MiFID in the EU) which enable them to reconstruct trades.

Question 25. Do you believe that the industry codes already meet some or all the recommendations? If so, please explain in detail how.

We see merits in IOSCO providing for a unique framework that would be harmonised throughout all asset classes, while allowing the necessary flexibility where deemed necessary. To do so, IOSCO should build on what already exists in industry codes and is therefore widely applied.