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ESMA Report

On the Call for Evidence on pre-hedging

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References and abbreviations

Legislative References

MAR	Regulation (EU) No 596/2014 of the European Parliament and of the Council of 16 April 2014 on market abuse (market abuse regulation) and repealing Directive 2003/6/EC of the European Parliament and of the Council and Commission Directives 2003/124/EC, 2003/125/EC and 2004/72/EC[1].
MiFID II	Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU[2].
MiFIR	Regulation (EU) No 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Regulation (EU) No 648/20123.
Delegated Regulation 2017/587	Commission Delegated Regulation (EU) 2017/587 of 14 July 2016 supplementing Regulation (EU) No 600/2014 of the European Parliament and of the Council on markets in financial instruments with regard to regulatory technical standards on transparency requirements for trading venues and investment firms in respect of shares, depositary receipts, exchange-traded funds, certificates and other similar financial instruments and on transaction execution obligations in respect of certain shares on a trading venue or by a systematic internaliser[4].
Delegated Regulation 2017/583	Commission Delegated Regulation (EU) 2017/583 of 14 July 2016 supplementing Regulation (EU) No 600/2014 of the European Parliament and of the Council on markets in financial instruments with regard to regulatory technical standards on transparency requirements for trading venues and investment firms in respect of bonds, structured finance products, emission allowances and derivatives[5].
Delegated Regulation 2017/565	Commission Delegated Regulation (EU) 2017/565 of 25 April 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive[6].

[1] OJ L 173, 12.6.2014, p. 1.
[2] OJ L 173 12.6.2014, p. 349.
[3] OJ L 173, 12.6.2014, p. 84.
[4] OJ L 87, 31.3.2017, p. 387.
[5] OJ L 87, 31.3.2017, p. 229.
[6] OJ L 87, 31.3.2017, p. 1.

Abbreviations

CBOE	Chicago board options exchange
CDS	Credit default swap
CFE	Call for evidence
EC	European Commission
ESMA	European Securities and Markets Authority
MAR Review CP	ESMA Consultation Paper on MAR Review Report 3 October 2019 (ESMA 70-156-1459)
EU	European Union
FINRA	Financial industry regulatory authority
FX	Foreign exchange
GFXC	Global foreign exchange code
M&A	Merger and acquisition
MTF	Multilateral Trading Facility
NCA	National Competent Authority
OTC	Over the counter
OTF	Organised Trading Facility
RTS	Regulatory Technical Standards
RFQ	Request for quote
RFM	Request for market (request for a two-way quote)
SI	Systematic internaliser

1 Executive Summary

Reasons for publication

ESMA originally addressed the practice of pre-hedging in its 2019 and 2020 MAR review. However, diverging views about pre-hedging emerged from the feedback received: some respondents considered that pre-hedging can be considered as a form of front-running, while others considered it as a regular market practice that is beneficial for clients and for the market as a whole.

ESMA did not provide a final view on pre-hedging at the time but committed to further look into the issue.

In July 2022, ESMA published a call for evidence on the subject, receiving 32 responses. In line with the feedback received in 2020, responses to the call for evidence expressed opposing views about the legitimacy of pre-hedging and on whether it is necessary for the market.

Contents

In this report ESMA provides an overview of the feedback received to the call of evidence, identifying elements which could be considered in any future guidance in this area.

In line with the call for evidence, ESMA has structured this report as follows: Sections 4 and 5 summarise the reactions to the proposed working definition of pre-hedging and the market views regarding some arguments in favour and against this practice. Section 6 presents the responses to how pre-hedging can be analysed from the MAR perspective, mostly in relation to the assessment of a request for quote (RFQ) as inside information and to some specific indicators of a possible legitimate/illegitimate behaviour. Finally, Section 7 addresses the views received regarding pre-hedging and MiFID/MIFIR, including the type of clients affected by the practice, the possible conflict of interest that may arise, and the obligation to act in the best interest of the clients in this context.

Next Steps

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.

2 Introduction

1. The practice of pre-hedging is not defined in EU law. Nevertheless, financial market participants understand pre-hedging as a practice which takes place when liquidity providers aim to hedge their inventory risk[7] in an anticipatory manner.

2. As an example, a liquidity provider expecting an order from a client may want to hedge the expected future risk arising from filling that order. To that goal, the liquidity provider undertakes one or several transactions to hedge the order before it is received.

3. In the context of the MAR Review, ESMA undertook a preliminary analysis of pre-hedging practices as some NCAs reported concerns from market participants on pre-hedging behaviours. ESMA noted that, despite pre-hedging often being motivated by a risk management rationale, the practice might raise concerns in terms of insider dealing, as a broker may be considered to have used the information received from the client about their incoming order to trade against the client.

4. In the Final Report on the MAR Review[8] ESMA acknowledged, based on stakeholders' feedback, that there are fundamentally diverging opinions on pre-hedging. It was therefore deemed necessary to further analyse this practice to avoid adopting interpretations or recommending practices which might have unintended consequences or even provide legitimacy to harmful behaviours and, to that end, in July 2022 launched a Call for Evidence (CFE). The CFE aimed at gathering additional evidence on the practice of pre-hedging on a more targeted set of elements.

5. ESMA received 32 responses to the CFE[9] which are presented in this report as follows: Section 4 analyses the reactions to the proposed working definition of pre-hedging; Section 5 elaborates on the arguments received in favour and against pre-hedging; Section 6 summarises the responses received to the questions on pre-hedging and MAR. Finally, Section 7 covers the views received on the interaction between pre-hedging and the MiFID II provisions.

6. As for the way forward, ESMA notes that pre-hedging takes place at a global level and across asset classes. In this respect, ESMA has analysed the existing cross-border initiatives to tackle this practice: the Global FX Code (GFXC) in the context of FX markets and the Financial Markets Standard Board (FMSB) Standard on large trades.

7. Considering the above, ESMA agrees with the views expressed by some stakeholders, requesting international coordination of any future ESMA action on pre-hedging to ensure a level playing field across EU and non-EU jurisdictions.

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[7] Market makers set bid and ask prices for financial instruments on a continuous basis and, in doing so, they face the so-called inventory risk. This can be defined as the risk market makers are exposed to when buying or selling a security, as prices of assets on their inventories could potentially move against them.
[8] https://www.esma.europa.eu/sites/default/files/library/esma70-156-2391_final_report_-_mar_review.pdf
[9] Note that some of the responses were confidential, therefore not published on the website.

8. Therefore, 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.

3 Working definition of pre-hedging

3.1.1 Background

9. In the context of the CFE, ESMA explained that despite the lack of a definition of pre-hedging in EU law, this practice is generally understood as hedging an inventory risk in an anticipatory manner in presence of a potential incoming transaction.

10. More specifically, in the CFE ESMA defined pre-hedging as any trading activity undertaken by an investment firm, where (i) the investment firm is dealing on its own account, and the trading activity is undertaken (ii) to mitigate an inventory risk which is foreseen due to a possible incoming transaction, (iii) before that foreseeable transaction has been executed, (iv) at least partially in the interest and benefit of the client or to facilitate the trade.

11. The CFE introduced two specific trading practices which can qualify as pre-hedging:

    (i) a liquidity provider trading, in the context of an RFQ, ahead of the acceptance of a quote from the client; and

    (ii) a liquidity provider trading ahead of a pending order.

12. ESMA asked views to market participants on the proposed definition.

13. Additionally, in the CFE ESMA discussed the difference between hedging and pre-hedging. The distinction was based on the consideration that hedging can be characterised as a risk reducing activity which takes place after the risk has been internalised by the liquidity provider, whilst pre-hedging is an anticipatory risk reducing activity based on the assumption of possible future inventory risk stemming from a potential incoming trade.

14. The CFE also touched upon a market practice named ‘last look’[10]. Market participants’ views were asked with respect to such issues and on the need to include other activities in the definition of pre-hedging.

[10] When the previous trading pattern of a client has led to price movements against the firm before it could hedge, the firm may modify the quote initially offered or reject the transaction.

3.1.2 Feedback to the call for evidence

3.1.2.1 Definition of pre-hedging

15. Respondents expressed heterogeneous views. Most agreed with the definition provided.

16. A number of respondents suggested possible clarifications[11] in the case of a liquidity provider trading ahead of a pending order (case (ii) as described in Section 3.1.1.).

17. Some of them considered case (i) in Section 3.1.1. as legitimate pre-hedging and noted that case (ii) does not in principle qualify as pre-hedging. They argued that if the price is the only variable to be determined to finalize the trade, the trading activity undertaken by the liquidity provider should be qualified as hedging. More specifically the respondents referred to a possible distinction among cases where a trade "proposal" has been submitted but the trade will be agreed and executed at a later stage and cases where the trade has been agreed, but some elements of the trade will be specified at a later stage.

18. Others remarked that a liquidity provider trading ahead of the acceptance of a quote from the client in the context of an RFQ (case (i) in Section 3.1.1.) could in some instances qualify as pre-hedging. However, it could also be deemed as front running, hence posing tangible risks in terms of market abuse.

19. Beyond the diverse views expressed on the definition of pre-hedging, several respondents stressed that the definition of pre-hedging should not encompass all trading activities involving the instrument (or related instruments) which arise due to regular management of the inventory. One respondent additionally remarked that pre-hedging is often conducted at portfolio level, hence the definition should be revised.

20. A small majority of respondents did not believe that any other activity should be considered when defining pre-hedging. Some of them invited ESMA to consider specific scenarios when providing guidance.

21. Several respondents remarked that ESMA guidance should not be tailored only to electronic RFQ systems, but rather be technology neutral.

22. A large majority presented their views regarding the legitimacy of the practice of pre-hedging (see Section 5 for a summary of the evidence presented). Despite the diverging views expressed, it appears that the majority believe that there are specific instances where pre-hedging is beneficial for financial markets, e.g. cases of very illiquid securities traded OTC and requiring customization of the trade. However, due

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to the diverging positions regarding the practice and its legitimacy, the scenarios presented were often different.

3.1.2.2 Pre-hedging and hedging

23. The majority of respondents agreed with the proposed distinction as presented in the above section. Some respondents remarked that case (ii) in the definition of pre-hedging should rather be considered as hedging.

24. Few respondents disagreed with the definition proposed in the CFE, either advocating a more encompassing definition of hedging, or noting that it is not possible to draw a clear difference between hedging and pre-hedging.

3.1.2.3 Last look

25. Respondents expressed diverse views on "last look" and the appropriateness of such practice. Nevertheless, most agreed that "last look" practices should not be considered in the context of pre-hedging but would deserve a more focussed discussion.

3.1.2.4 Conclusions

26. ESMA notes that most of the respondents are in agreement with the definition of pre-hedging proposed in the CFE. As a consequence, ESMA considers that the proposed definition of pre-hedging could be used as a starting point for further guidance.

27. With respect to the difference between hedging and pre-hedging ESMA understands this can be subject to diverse interpretations and deserves further discussion.

28. With respect to "last look" practices, ESMA overall shares the view that, if needed, such practices should be addressed separately.

4 State of play and market views on the need for pre-hedging

4.1.1 Background

29. Taking the feedback gathered in the context of the MAR Review as a starting point, in the CFE ESMA undertook further research on pre-hedging, also considering sectorial guidance present in the market and invited stakeholders to provide their views.

30. Starting with the arguments against this practice, ESMA presented the views of some market participants who argued that these risks are more pronounced when clients

request quotes from two or more liquidity providers (i.e. competitive RFQs[12]) or for RFQs in liquid or very liquid assets.

31. Separately, ESMA included in the CFE reference to one academic paper suggesting that dealers pre-hedging derivative transactions through a trade in the underlying asset might drive the derivative transaction to a price level which is more favourable to them and less favourable to their clients[13]. The authors explain that it is possible for a dealer to either protect the customer's interests by executing the hedge trade in a way that minimizes its price impact or to exploit the conflict of interest by executing the hedge trade in a way that significantly impacts prices. Their conclusion is that liquidity providers tend to exploit this conflict of interest and influence prices when they have an incentive to do so.

32. Considering the arguments in favour of pre-hedging, in the CFE ESMA considered pre-hedging to be a frequent practice in financial markets that is not banned in other jurisdictions, provided that certain requirements are met, such as in the US the FINRA Rule 5270[14].

33. Along the same line, ESMA included a reference to the GFXC (Principle 11[15] and guidance paper[16]) and the FMSB standard for the execution of large trades in FICC markets[17] which described the factors under which pre-hedging would be deemed acceptable.

34. The CFE also included some general arguments by some firms in favour of pre-hedging presented in the MAR Review CP, claiming that a market risk reduction is achieved, translating into better quotes offered to clients, volatility and costs for the market as a whole are reduced.

4.1.2 Feedback to the call for evidence

35. In line with the CFE, it appears useful to tackle the arguments against and in favour of pre-hedging separately.

Arguments against pre-hedging

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[12] In certain markets obtaining quotes has traditionally been achieved by simultaneously polling multiple counterparties and comparing quotes from different parties. This is a process that has increasingly become automated, permitting the submission of competitive RFQs through electronic platforms.
[13] Henderson, B., Pearson, N. and Wang, L., 2020. Pre-trade hedging: Evidence from the issuance of retail structured products. Journal of Financial Economics, 137(1)
[14] https://www.finra.org/rules-guidance/rulebooks/finra-rules/5270
[15] https://www.globalfxc.org/docs/fx_global.pdf
[16] GFXC: commentary on Principle 11 and the role of pre-hedging in today's FX landscape https://www.globalfxc.org/docs/commentary_principle_11_role_prehedging.pdf
[17] https://fmsb.com/wp-content/uploads/2021/05/FMSB_Large_Trades_Standard_-FINAL-05.05.21.pdf

36. Respondents presented mixed views. Those generally against pre-hedging supported the points mentioned in the CFE while stakeholders considering pre-hedging as legitimate did not agree with most of them.

37. Two stakeholders in favour of pre-hedging stated the view that it is inaccurate to determine the legitimacy of pre-hedging depending on the liquidity of the underlying market as there could be a clear risk management rationale also when pre-hedging in liquid markets, as market liquidity conditions can change very quickly.

38. One stakeholder mentioned that the legitimacy of pre-hedging depends on its nature: where it consists of merely trading in comparable size and in the same direction of the RFQ, it might be identified as front-running. But where the pre-hedging takes place through trading in highly diversified instruments or indices, it appears justified.

39. A number of respondents indicated that pre-hedging in competitive RFQ markets compromises market integrity, irrespective of the RFQ trading protocol used (automated/electronic, chat or voice), as it results in increased price slippage costs. They further mentioned that pre-hedging might create an uneven playing field in the context of a competitive RFQ, if one liquidity provider pre-hedged the foreseeable transaction while the others did not.

40. Beyond the arguments against pre-hedging, a new element of so-called 'free-optionality' emerged from the consultation. For one stakeholder 'free-optionality' means that liquidity providers pre-hedging incoming transactions might benefit from price movement and might not pass on this benefit to the client. Alternatively, they might amend their initial quote in instances where pre-hedging moves prices against them. In both cases, the end result would be that the liquidity provider shifts their market risk to the client.

41. Respondents to the CFE did not raise any comments in relation to the academic evidence presented by ESMA.

<u>Arguments in favour of pre-hedging</u>

42. With respect to the arguments in favour of pre-hedging in the CFE, respondents supporting the practice pointed out that such arguments are valid and should be taken into account when issuing any type of guidance on this topic. They reiterated that pre-hedging brings a variety of benefits to the market, including enabling the execution of orders (especially large orders) that would otherwise be complex to execute. They also noted that pre-hedging is a necessary tool for banks and investment firms to effectively manage their risk.

43. Some respondents emphasized that pre-hedging positively increases competition, increasing the number of liquidity providers in the market and enabling orders' execution. Without pre-hedging, only global brokers would be able to take the risk of quoting prices in the market, to the detriment of competition. Another respondent

mentioned that this practice is in some instances a necessary pre-condition for other transactions, such as M&A transactions or bond issuances.

44. Separately, some respondents suggested that the FINRA Rule 5270 should not be read as an argument in favour of pre-hedging. Instead, it should be seen as a narrow exception for instances where a trade has been agreed, but the price will be determined at a later stage, or where the trade has been completed but not yet published.

45. Finally, a couple of stakeholders suggested that ESMA should coordinate, to the extent possible, any future guidance on pre-hedging with other supervisory authorities at global level in order to ensure a level playing field across different jurisdictions beyond the boundaries of the EU.

4.1.3 Conclusions

46. Based on the feedback received, it appears that market participants have diverging views on pre-hedging and stakeholders can be divided into two different categories: those in favour and those against pre-hedging.

47. With respect to the legitimacy of pre-hedging, ESMA notes that market participants already benefit from pre-trade transparency waivers and post-trade deferrals under the MiFID II regime. These transparency regimes aim to prevent that orders or transactions meeting certain requirements are exposed to the market before the relevant parties have had the opportunity to hedge them.

48. ESMA also understands that some market participants operating in the financial markets engage in pre-hedging while some others do not. ESMA is conscious that some stakeholders consider pre-hedging necessary when providing quotes for certain less liquid instruments.

49. At the same time, ESMA acknowledges that some of the arguments presented against pre-hedging in terms of possible abusive behaviour or exploitation of the conflict of interest cannot be disregarded.

50. Overall, ESMA concludes that pre-hedging is a voluntary market practice which might give rise to conflicts of interest or abusive behaviours. These risks should be taken into account when issuing any future guidance.

51. Separately, ESMA undertook further research on the FINRA Rule 5270. To that end, it should be remembered that Rule 5270 foresees that no member should place an order in a security (or related financial instrument) when it has material and non-public market information concerning an imminent block transaction in that security, a related financial instrument or a security underlying the related financial instrument, before the information is made public or it has become obsolete.

52. Where the rule applies, pre-hedging may be permitted under certain conditions by means of exceptions to Rule 5270. Specifically, the trading firm must carry out these transactions to fulfil or facilitate the execution of the customer block order and, among other things, should minimize potential disadvantages or harm in the execution of the client's order. It should not place its financial interests ahead of those of the client and must obtain the customer's consent to such trading activity.

53. However, an analysis of the application of the rule depends on the specific facts and circumstances of the relevant trading scenarios.

54. Furthermore, ESMA notes that the rules of several U.S. trading venues mention the possibility of pre-hedging (or anticipatory hedging) in relation to block trades[18]. Further analysis should be made to determine whether these rules cover the case of a liquidity provider trading ahead of the acceptance of a quote from the client.

55. Finally, ESMA agrees with the views expressed by some stakeholders on the need to coordinate efforts at the international level considering the cross-border dimension of pre-hedging. In this respect, ESMA concludes that global regulatory principles applicable to pre-hedging could imply a major improvement. Those principles might contribute to the development of any future ESMA guidance.

5 Pre-hedging and MAR

5.1 RFQ as inside information

5.1.1 Background

56. In the CFE, ESMA gathered evidence on whether an RFQ can be considered as inside information pursuant to the general definition of inside information contained in Article 7(1)(a) of MAR.

57. Article 7(1)(a) of MAR classifies as inside information any information, which i) has not been made public, ii) which is of a precise nature, iii) relates, directly or indirectly, to one or more issuers or to one or more financial instruments, and iv) which, if it were made public, would be likely to have a significant effect on the prices of those financial instruments or on the price of related derivative financial instruments.

58. In the CFE, ESMA concluded that an RFQ regarding a specific instrument would always be directly related to the financial instrument it refers to, as it entails a potential transaction on such an instrument. In addition, ESMA considered that an RFQ can be considered as non-public information.

[18] In particular, ESMA mentioned the rules of Intercontinental Exchange in the call for evidence: https://www.theice.com/publicdocs/futures_us/exchange_notices/Block_Trade_FAQ.pdf

59. With respect to the preciseness of the information, ESMA sought views on whether a foreseeable transaction could qualify as specific enough to draw a conclusion on its effect on the price. In that context, ESMA recalled the decision of the Court of Justice of the European Union (CJEU) in the case Lafonta vs. Autorite des Marches Financiers, where the CJEU concluded that a particular item of information can be deemed to be precise even if it does not make it possible to predict whether the prices of the financial instruments concerned will increase or decrease, as long as a price variation is expected.

60. ESMA requested the views of market participants on whether a two-way quote (also known as request-for-market or RFM) may also be considered precise when the receiving liquidity provider could deduce the trading intentions of the client based on e.g. past commercial relationship, market conditions, news flow, etc.

61. Finally, with respect to the price sensitivity, in the CFE ESMA considered that, based on MAR, information is price sensitive if reasonable investors would be likely to use it as part of their investment decision. This appears to be the case when the transaction corresponding to the upcoming RFQ would have a significant effect on the price of the financial instrument.

62. In assessing when the price impact can be considered significant, ESMA noted that a number of factors may potentially come into play and gathered views on whether, amongst others, the size of the RFQ should be considered as the most relevant indicator. ESMA also asked market participants what other indicators, apart from those stated in the CFE, should be considered in assessing the impact of the RFQ on the price of the relevant financial instrument.

5.1.2 Feedback to the call for evidence

63. ESMA received feedback from a well-diversified range of stakeholders who, as already mentioned in several sections of this report, expressed diverging views. The questions asked in the CFE focused on the elements of precision and price sensitivity of the upcoming RFQ, but respondents also provided general views on RFQs as inside information.

<u>General views on RFQ as inside information</u>

64. On the general analysis, the majority of respondents argued that RFQs should not be considered as inside information on a systematic basis, but a case-by-case assessment would always be needed. It was also mentioned that equating RFQs to inside information would depart from the current reading of MAR.

65. Numerous respondents also considered that no additional guidance is needed on whether an RFQ can amount to inside information as the MAR framework is already comprehensive enough.

RFQ as non-public information

66. While most respondents generally agreed that RFQs could be non-public information, one trading venue noted that in case of “all-to-all” RFQ protocols offered by some venues, an unlimited number of potential liquidity providers may respond to an RFQ. In this case it should not be considered as non-public information.

Precision of RFQs and RFMs

67. With respect to the element of precision, a couple of respondents considered that for an RFQ to be precise it would need to contain instrument, direction (buy or sell) and quantity.

68. When looking at RFMs, respondents had mixed views on whether those could be considered precise enough. Some stakeholders disagreed, noting that a firm order must be placed before the information can be considered as sufficiently precise. Another group of respondents had a different view, arguing that RFMs can be considered precise as the direction of trade is not that relevant for assessing the price impact.

69. Respondents also expressed diverging views on whether an RFM could be considered as precise information if the liquidity provider could discover the trading intentions of the client on the basis of any past commercial relationship, market conditions, the news flow, etc.

70. On the one hand, the majority of stakeholders generally supportive of pre-hedging considered that there would not be enough certainty to allow the liquidity provider to draw any conclusions on the direction of the trade. One respondent also pointed out that liquidity providers do not have visibility on how many, and which liquidity providers have been approached. It is therefore difficult to infer accurate information based on past commercial relationships.

71. On the other hand, a smaller group of stakeholders considered that, where the liquidity provider who is in receipt of an RFM can determine the likely side of the forthcoming transaction, the RFM should be regarded as “precise information”. It was also mentioned that liquidity providers generally know in which way clients are trading even if they ask for a two-way price.

Price sensitivity of RFQs

72. With respect to the price sensitivity of an RFQ, the great majority of stakeholders agreed with the criteria suggested by ESMA in the CFE. There was general consensus on the fact that the size of the RFQ, the market liquidity, the type of financial instrument as well as any relevant news on the market, should be taken into account when assessing the price sensitivity of an RFQ. A few stakeholders stressed that the RFQ’s size is a relevant parameter but not the most important one.

73. However, some respondents made clear that a case-by-case assessment is necessary to assess the price impact of an RFQ, noting that some of the factors mentioned above are subject to daily (or intraday) variations. As a general point, they considered that a list of criteria that could potentially have a significant impact on price would not be specific enough as it would not take into account the dynamics of the different types of instruments and markets.

5.1.3 Conclusions

74. ESMA acknowledges that most market participants consider that a case-by-case analysis should be carried out in order to assess whether an RFQ amounts to inside information. ESMA also notes that most respondents agree that such assessment should consider at least the parameters suggested by ESMA in the CFE.

75. ESMA remains of the view that the case-by-case approach appears necessary to assess whether an RFQ can be considered as inside information. The above-mentioned CJEU decision in the Lafonta vs. Autorite des Marches Financiers has to be considered in such case-by-case assessment.

76. At the same time, ESMA notes that the feedback received from market participants suggests that there might be instances where all the requirements to qualify as inside information might not be met. This can be due to the trading protocol (e.g. all-to-all) or to specific trading features (e.g. RFMs).

5.2 Indicators of legitimate and illegitimate behaviour under MAR

77. In the CFE, ESMA requested the views of market participants regarding three possible parameters that can be used to evaluate the legitimacy of pre-hedging practices under MAR: i) the subjects who could legitimately pre-hedge foreseeable transactions; ii) the existence of a risk management rationale and iii) the interest of the client.

5.2.1 Subjects who could legitimately pre-hedge a foreseeable transaction

5.2.1.1 Background

78. First of all, ESMA looked at the subjects who could legitimately pre-hedge foreseeable transactions, starting from the first example presented in the FICC Market Standards Board in its Standard[19] for the execution of large trades.

79. In this case, the dealer makes clear to the client that it will be acting as agent and will add a fee. As a result, the risk related to the transaction is borne by the client, and the pre-hedging transaction undertaken by the agent does not respond to any risk

[19] See Core principle 2:Pre-hedging is not admissible in a scenario where the dealer is acting as an agent. https://fmsb.com/wp-content/uploads/2021/05/FMSB_Large_Trades_Standard_-FINAL-05.05.21.pdf

management rationale. In the absence of any risk, the relevant Standard excludes pre-hedging can be undertaken when acting as an agent.

80. ESMA noted that this approach seems consistent with the one followed by the Canadian authorities and in the US[20] and the GFXC, which states that pre-hedging client orders is only possible when acting as a principal[21].

5.2.1.2 Feedback from the call for evidence

81. Despite ESMA not having specifically asked in the CFE whether agents could pre-hedge, some answers stressed that a risk management rationale can exist only when the trader acts as a principal.

82. Overall, the replies confirm that pre-hedging is an activity that is relevant only for those trading on their own account.

5.2.1.3 Conclusions

83. In light of the feedback to the consultation it is possible to conclude that only principals trading on their own account can pre-hedge legitimately. On the contrary, agents who do not undertake any risk in concluding a transaction for their clients have no reason to engage in such a practice.

5.2.2 Risk management

5.2.2.1 Background

84. After noting that pre-hedging needs to reply to risk management necessities, in the CFE ESMA looked at (i) cases where pre-hedging would be necessary for these purposes, (ii) the link between the likelihood of the execution of a transaction and pre-hedging (iii) the instruments used for pre-hedging.

<u>Cases where pre-hedging would be necessary</u>

85. In respect to cases where pre-hedging would be necessary, ESMA in the CFE asked the views of market participants on whether the cases described in the GFXC Guidance on pre-hedging[22] adequately identify the risk management rationale that could justify such activity.

[20] See the Canadian UMIR – IIROC and Section 12 of CME rules for block trades: Parties to a potential block trade may engage in pre-hedging or anticipatory hedging of the position that they believe in good faith will result from the consummation of the block trade, *except for an intermediary that takes the opposite side of its own customer order*. (https://www.cmegroup.com/content/dam/cmegroup/notices/market-regulation/2016/10/RA1613-5.pdf). See as well, ICE Futures U.S., NASDAQ Futures Inc., CBOT, NYMEX and COMEX rules.

[21] See Principle 11: A Market Participant should only Pre-Hedge Counterparty/client orders when acting as a Principal, and should do so fairly and with transparency.

[22] https://www.globalfxc.org/docs/commentary_principle_11_role_prehedging.pdf

86. The GFXC code entails the following cases: (a) market risk exposure is reduced by allowing a liquidity provider to accumulate offsetting inventory in the trading book; (b) the hedge cost is lowered by lengthening the window over which the liquidity providers can hedge the new exposure by permitting transactions also before the risk transfer takes place; and (c) market liquidity is tested through pre-hedging in the absence of validation through other sources (e.g. historical data).

87. ESMA in the CFE asked whether the GFXC guidance described all the possible cases of risk management rationale that could justify pre-hedging, and to provide examples on pre-hedging practices with/without a risk management rationale.

Necessary link between pre-hedging and the likelihood of executing a transaction

88. In relation to the likelihood of executing a transaction, ESMA firstly considered the GFXC's commentary on Principle 11[23]. Principle 11 admits pre-hedging as legitimate when "*the liquidity provider anticipates in good faith (that is, has reasonable expectations) that the liquidity consumer will accept the quote in which case it will become a confirmed transaction*".

89. Similarly, core Principle 7 of the Standard on the execution of large trades on FICC markets indicates that pre-hedging should only be undertaken when the dealer legitimately expects to take on market risk.

90. In line with that, ESMA noted that there is no risk to pre-hedge if a transaction is not going to be concluded. On this basis, ESMA asked whether pre-hedging is considered illegitimate by market participants when liquidity providers estimate that it is unlikely to be awarded with the transaction.

Financial instruments used for pre-hedging

91. On the financial instruments used for pre-hedging, in the CFE ESMA recalled one of the responses to the MAR Review CP regarding corporate bond issuances.

92. That response indicated that where liquidity providers are hired to carry out the placing and the underwriting of a corporate bond issuance and know in advance when such issuance will take place, pre-hedging by means of CDS on highly diversified indices of corporate bonds should be permitted. However, pre-hedging by means of transactions in the outstanding corporate bonds of the issuer or in CDSs on the issuer and entities related to the issuer should be considered as an indicator of market abuse.

[23] Principle 11 reads as follows "an anticipated order can be best illustrated through a voice one-way RFQ, in which a liquidity consumer requests one or more liquidity providers to provide a firm quote on a specified transaction amount. The act of requesting the quote does not mean that the liquidity consumer will accept or trade on the quote. The decision whether to trade and accept the quote lies with the liquidity consumer. However, the liquidity provider anticipates in good faith (that is, has reasonable expectations) that the liquidity consumer will accept the quote in which case it will become a confirmed transaction".

93. Furthermore, ESMA noted that for most financial instruments, liquidity providers hedge their risk's exposure mainly through the use of derivatives, such as options or index futures. However, pre-hedging can also occur through additional transactions in the financial instrument that is the subject of the RFQ, or in the case of options through similar options (e.g. same underlying or same maturity).

94. ESMA requested the views of market participants on whether pre-hedging through certain financial instruments should be considered as an indicator of legitimate/illegitimate trading activity.

5.2.2.2 Feedback to the call for evidence

Cases where pre-hedging would be necessary

95. Almost half of the respondents to the CFE recognised the GFXC guidance as a good starting point to identify cases of risk management that could justify pre-hedging. However, some of them pointed out that the GFXC guidance is focused on a specific market. Responses also suggested that other guidance, such as the one provided by the FMSB, should be considered as well. Overall, according to those respondents the divergences across RFQ markets demands an in-depth analysis of each different practice, and it impedes the adoption of a "one size fits all" approach.

96. Other respondents rejected an exhaustive list of legitimate pre-hedging cases and indicated that each conduct should be evaluated on a case-by-case basis, to take into account the differences across markets.

97. Some respondents pointed out that the risk management rationale of pre-hedging only considers the benefit for liquidity providers and does not take into consideration unfavourable outcomes for clients, or competition in general. One response warned that the GFXC cases of necessary pre-hedging may cause disadvantage for clients and result in poorer quoted prices. Thus, this group recommended regulators to consider the impacts of the practice on the wider market.

98. Most of the respondents were not able to provide further examples of pre-hedging practices with/without a clear risk management rationale.

99. Some respondents indicated that the difficulty in identifying when pre-hedging has (or has not) a risk management rationale derives from the fact that practical examples are case-specific, differing from market to market.

100. Other responses proposed that legitimate cases should include (i) the case where pre-hedging allows reduction of the risk on the liquidity provider's book and (ii) where the last look or final exchange validation is pending.

101. As a general comment, some responses pointed out that the risk management rationale is a qualifying element of pre-hedging and therefore it should be included in its definition.

Necessary link between pre-hedging and likelihood of executing a transaction

102. Most respondents exclude that pre-hedging can be legitimate when the market participant is aware, on the basis of objective circumstances, that they will not be awarded the transaction.

103. Many respondents warned that it is difficult to identify ex-ante circumstances suggesting that a transaction will be/ or will not be concluded. The context of each transaction is different, so a case-by-case assessment becomes necessary.

104. Few respondents expressed that it is impossible to have the reasonable expectation to conclude the trade, especially in the electronic context. Another respondent indicated that only under strong objective reasons to be awarded the transaction, which are unlikely to occur, pre-hedging should be legitimate.

105. One response indicated that the distance between the quote and the market spread is not a reliable indicator for the transaction to be concluded. This is especially true for market makers whose role entails to define (and therefore to move) prices on the market.

Financial instruments used for pre-hedging

106. With respect to the financial instruments that can be used to pre-hedge, there is consensus among respondents in considering that all types of financial instruments can be used to pre-hedge.

107. Few respondents stressed that the choice of the financial instruments used for pre-hedging occurs on a case-by-case basis. Others remarked that pre-hedging may involve the same instruments subject to an RFQ or derivatives of those instruments. One respondent highlighted that as far as the instrument traded is related to the one the RFQ relates to, the transaction could be qualified as having a pre-hedging objective.

108. One respondent indicated that pre-hedging could be especially beneficial for less liquid instruments (e.g. less liquid options markets). Another pointed out that trading on highly diversified financial instruments should 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.

5.2.2.3 Conclusions

109. The replies to the CFE show that market participants support a case-by-case assessment of the different practices. This choice is motivated by the divergences in the functioning of the different markets, which impedes the adoption of detailed rules applicable to all markets in the same way.

110. In this context, the existing GFXC and the FMSB guidance can be used as a good starting point to identify legitimate practices. However, they should be adapted to the specificities of each market.

111. Despite the general preference for a case-by-case guidance, there is agreement on considering that pre-hedging cannot be considered legitimate when there is no expectation to conclude the transaction. In that case, the transaction does not reply to any risk management rationale, and thus the liquidity provider's interest seems to be the only reason for pre-hedging.

112. However, when the transaction can be reasonably expected to be concluded it remains to be assessed through a case-by-case assessment. Such assessment should consider the different circumstances under which the transaction took place, as well as the specifics of the relevant market.

113. In respect to the instruments used for pre-hedging, ESMA notes that there is agreement that any type of instruments related to the RFQ can be used for pre-hedging purposes in respect to that RFQ.

114. Nonetheless, ESMA would see merit in further assessing whether the use of highly diversified financial instruments could be a possible indicator of legitimate pre-hedging activity in the context of a case-by-case assessment.

5.2.3 Interest of the client

5.2.3.1 Background

115. In the CFE, ESMA explored whether one of the elements that can be used to differentiate front-running from pre-hedging is whether the practice has been conducted for the benefit of the liquidity provider.

116. In this respect ESMA noted that pre-hedging could be beneficial for the client when it permits the liquidity provider to ensure the execution of the transaction and/or to offer better quotes, whereas it can be detrimental to the client when it moves prices against him.

117. On this basis, ESMA differentiated between: (1) where the liquidity provider only pursues its own interest; (2) the transaction is in the sole interest of the client and (3) the transaction is in the interest of both the client and the liquidity provider.

118. In the CFE, ESMA indicated to be analysing whether case (1) and (3) may correspond to front-running. It however highlighted that a benefit for the client would clearly exist where all or part of the financial gain made by the liquidity provider is transferred to the client or when pre-hedging would ensure the execution of the transaction for the client that would have not been possible otherwise.

119. ESMA also requested the views of market participants on whether the client's express consent to pre-hedging could constitute a strong indicator of pre-hedging undertaken in the interest of the client.

120. On this point, ESMA noted that obtaining the client's consent for each RFQ sent may not always be feasible, especially when RFQs are sent electronically. Thus, ESMA requested the views of market participants on how such consent can be obtained in the case of electronic and competitive RFQs.

121. ESMA also requested examples of practices conducted mostly in the interest of the liquidity provider.

122. To conclude the part on the indicators of legitimate and illegitimate behaviour under MAR, ESMA asked if it would be feasible for liquidity providers to provide evidence of (i) their reasonable expectation to conclude the transaction; (ii) the risk management needs behind the transactions; (iii) the benefit for the client pursued through the transaction and (iv) the client's consent.

123. Lastly, ESMA asked markets participants' view on the indicators of legitimate and illegitimate pre-hedging presented in the call for evidence.

5.2.3.2 Feedback to the call for evidence

Consent of the client

124. Some of the respondents to the CFE consider that the consent of the client is important to determine whether the transaction is in their interest and legitimate. Therefore, they supported express consent on a trade-by-trade basis.

125. In respect to whether consent can be the basis for a presumption of legitimacy of the liquidity provider's behaviour, some respondents provided a positive answer. However, some of them noted that consent alone does not prevent illegitimate behaviour from occurring. Thus, they suggested that the presumption should be rebuttable and the consent should always concur with other indicators.

126. Very few respondents were openly against a presumption of legitimacy based on consent. One respondent indicated that pre-hedging should always be considered legitimate, thus no indicators are needed to identify legitimate practices. Another respondent indicated that the legitimacy of the practices should be determined exclusively by the risk mitigating effects of the transactions. One respondent indicated

that the request for consent would add a burden for firms. Another respondent indicated that compliance with the best execution rules reflects the pursuit of the interest of the client.

127. Overall, there seems to be agreement on considering that the collection of the client's consent may not be possible in all market types, or in any context in which the transaction takes place.

128. More specifically, there seems to be unanimity in considering that the collection of the client's consent for each transaction is not feasible for electronic trading. In this context, current best practices include a general disclosure (for example through the website), whereas ad hoc specific disclosure is foreseen only where necessary.

129. According to two respondents, it would be technically feasible to express consent on a trade-by-trade basis through electronic means such as single or multiple dealer platforms or application programming interfaces (API).

Pre-hedging practices conducted mostly in the interest of the liquidity provider

130. Almost no respondents provided concrete examples of practices that clearly damage the clients.

131. For practices that are clearly illegitimate, one respondent pointed out to the case where the trader knows he cannot execute the transaction.

132. More in general, respondents in favour of pre-hedging indicated that the benefits of pre-hedging practices for clients are always present because pre-hedging always permits to provide a better price to the client, and as the practice reduces risk of firm failures, it benefits the overall markets.

133. An additional respondent indicated that even if pre-hedging is not in the interest of the client, it still does not constitute a MAR infringement. Furthermore, one respondent - quoting Principle 11 of the FX Global Code - indicated that pre-hedging by definition has always to be to the benefit of the client.

134. Taking the opposite stand, some firms indicated that pre-hedging is more likely to damage the client by moving the prices against him, rather than bringing any benefit, and thus conclude that pre-hedging should generally be considered illegitimate.

Concluding questions about the indicators of legitimate/illegitimate behaviour

135. As to the provision of evidence on the indicators of legitimate/illegitimate behaviour, the feedback was mixed.

136. The majority of responses indicated that it would not be possible to provide such evidence, finding different arguments against such provision (the increased

administrative burden would lead to a reduction of liquidity in certain markets; such evidence would be linked to the overall trading activity of the pre-hedging firm, etc.).

137. Only a small minority of respondents considered that liquidity providers should be able to provide that evidence, noting that the existing MiFID II and MAR record-keeping requirements could be used for this aim, without need for any additional obligation.

138. Lastly, when expressly asked on the indicators put forward by ESMA, very few respondents were vocal in supporting the use of the following indicators to identify legitimate pre-hedging practices: (i) the risk management purpose; (ii) the quality of principal of the trader; (iii) likelihood of the transaction; and (iv) the interest of the client. However, there was no express opposition either. Furthermore, replies showed that the criteria presented were used by respondents to argue in favour or against pre-hedging.

139. Two of those respondents pointed out to liquidity as an additional indicator to be taken into consideration to demonstrate the client's benefit. The same respondents added that such indicator should not be prescriptive.

140. One respondent reiterated the importance of a case-by-case approach in determining whether the transaction is legitimate, and they recommended that any list of indicators should be non-exhaustive and non-binding. The same stand has been expressed by other respondents in respect to other parts of the CFE.

141. One respondent indicated that the FMSB standards under Principle 7 already provide a set of criteria to identify when pre-hedging practices should be allowed[24] and that the GFXC (July 2021), under the section "Controls and Disclosures around pre-hedging", provides a list of procedures to undertake in order to fairly handle client orders. Consequently, in their view, pre-hedging activities which are compliant with the GFXC should be considered legitimate.

142. One respondent warned that the indicators presented may not be met in the competitive environment, as in that context (i) there is no certainty to be awarded the transaction, (ii) clients may receive a worse outcome from pre-hedging especially when multiple liquidity providers pre-hedge, and (iii) transparency to clients and their consent to pre-hedging transactions cannot be provided effectively in automated, electronic RFQ protocols.

143. Two respondents indicated that "the financial interest" of the parties should not be taken into consideration to evaluate the "interest of the client" and the overall legitimacy of the transactions. Another respondent indicated that the interest of the

[24] These cases include where (i) the market maker has a legitimate expectation to take on market risk and pre-hedging is undertaken at its own risk; (ii) when the trading activity is reasonable relative to the size and nature of the anticipated transaction; (iii) when pre-hedging aims at minimising the impact of the activity on the market; and (iv) when this is designed to benefit the counterparty/client".

client may be difficult to identify but could appear in the form of narrower spreads or in the ability of the liquidity provider to offer a quote or a transaction.

5.2.3.3 Conclusions

144. Respondents generally use the indicators set forth by ESMA to distinguish between legitimate and illegitimate practices. ESMA therefore concludes that such indicators are valuable to distinguish between legitimate and illegitimate practices.

145. ESMA acknowledges the strong preference expressed for the case-by-case assessment proposed in the CFE to determine the legitimacy of the practice. In line with that, ESMA concludes that any future guidance could consider the presented indicators as non-binding and as part of a case-by-case assessment.

146. In respect of the consent of the client, ESMA notes that respondents share the view that it is an important element to determine whether the transaction is in the interest of the client and legitimate. Furthermore, there was support for express consent on a trade-by-trade basis.

147. At the same time, ESMA notes that there is also general agreement on considering that consent alone does not prevent illegitimate behaviour from occurring. Thus, ESMA concludes that consent could be used as an indicator in any future guidance, but only as a rebuttable presumption of legitimacy, and it should always concur with other indicators and/or elements to be considered.

148. Respondents agree that the capacity to obtain the consent of the client for each transaction depends on the type of market considered. More specifically, consent for each transaction seems to be difficult in electronic trading.

149. On this point, ESMA is of the view that further evaluations need to be made, as on the one hand there seems to be support for requiring the client consent for each transaction, and on the other hand the measure seems difficult to adopt in some instances, in particular when the RFQ takes place in an electronic context or not.

150. In respect to practices which appear to be in the interest of the liquidity provider or in the interest of the client, ESMA notes that the replies to the CFE are divided in two opposite groups. One group claims that pre-hedging is always in the interest of the client as it permits to offer better quotes or allows for the transaction to take place, whereas the other warns that pre-hedging may move the price against the client's interest.

151. In light of this, ESMA understands that both groups consider the interest of the client as an important element to define the legitimacy of the practice. Therefore, ESMA concludes that future guidance could list the interest of the client among the criteria to support the identification of legitimate pre-hedging in the context of a case-by-case assessment.

152. Lastly, in respect of the provision of evidence on the other indicators of legitimate/illegitimate behaviour (the reasonable expectation to conclude the transaction; the risk management needs and the benefit for the client behind the pre-hedging transactions and the client's consent), ESMA acknowledges the issue could be further assessed taking into consideration the record keeping requirements set forth by MiFID II.

5.3 Is the liquidity of the instrument an indicator of possible illegitimate behaviour?

5.3.1 Background

119. In the CFE, ESMA presented the view expressed by some market participants in the MAR Review CP, which considered that pre-hedging might be necessary for illiquid instruments whereas it does not seem to be justified for readily available instruments.

120. Indeed, these respondents considered that pre-hedging undertaken by a firm on its own account following a client's RFQ in a liquid instrument would not seem necessary, whilst pre-hedging transactions in illiquid instruments appear to have a stronger risk-management rationale because the intervention of liquidity providers might be necessary to facilitate trading and to sustain liquidity.

121. In light of the feedback received, ESMA decided to look more closely at whether the liquidity of the instrument could be an indicator of possible illegitimate behaviour. When drafting the CFE, ESMA could not gather any clear evidence to consider that pre-hedging transactions in liquid instruments is an indicator of possible market abuse but decided nonetheless to ask for the view of the market.

5.3.2 Feedback to the call for evidence

153. Respondents to the CFE had mixed views. It should however be noted that the great majority of respondents pointed out that the liquidity of a financial instrument should not be considered, on a stand-alone basis, as an indicator of possible abusive behaviour. In particular, those respondents considered that that should be assessed on a case-by-case basis alongside with other parameters such as the transaction size, type of financial instruments, relevant news on the market, bearing also in mind that such factors can evolve rapidly.

154. There seemed to be also a consensus among those stakeholders on the fact that pre-hedging can be considered as legitimate in liquid markets as in illiquid ones, considering that liquidity providers still need to manage risks by pre-hedging for liquid instruments. In fact, respondents noted that liquidity providers need to manage their risk taking into consideration not only the liquidity of the underlying instrument but also other factors such as the size of the transaction, the market conditions at the time of

the transaction, and their possible evolution (e.g. transaction being negotiated before a significant announcement).

155. In addition, a few stakeholders pointed out that liquidity in the market can change quickly, even intra-day, also depending on factors such as the introduction of large orders or a large volume of orders.

156. Two respondents noted that it is the market structure context in which the pre-hedging activity occurs, rather than the liquidity of the instrument, that is relevant to determine whether a practice is abusive or not[25].

157. On the other side, two other respondents considered that liquidity is a relevant indicator to assess whether pre-hedging may be illegitimate behaviour and that carrying out such practice on liquid instruments does not have any risk management rationale.

5.3.3 Conclusions

158. ESMA acknowledges that the great majority of the responses to the CFE suggested that liquidity should not be considered as an indicator of illegitimate behaviour.

159. However, ESMA remains of the view that any future guidance should be built on the basis of the case-by-case analysis of a series of indicators, among which liquidity, which should support whether pre-hedging a foreseeable transaction was necessary or not and whether it has had any negative impact on the client's conditions.

6 Pre-hedging and MiFID/MiFIR

6.1 Type of clients impacted by pre-hedging

6.1.1 Background

160. In the CFE, ESMA noted that pre-hedging takes place in the 'wholesale markets' space, mostly between investment firms and eligible counterparties[26]. As a

[25] These respondents argued that pre-hedging in electronic RFQ markets is not justified whilst in markets where there are fewer dealers and where bilateral negotiation with a dealer is the preferred execution method, pre-hedging with the trade-by-trade consent of the client could reasonably be permitted.

[26] MiFID uses counterparty/client 'categories' to recognise that investors/counterparty/clients have different levels of experience, knowledge and expertise, and subsequently tailors regulatory protections provided by firms to those investors accordingly. Under this regime, investors will be retail counterparty/clients, professional counterparty/clients or eligible counterparties (ECPs).
Firms must provide counterparty/clients with one of these categorisations at the start of the relationship and are expected to keep that categorisation under review. Investors will automatically be categorised upon meeting certain criteria (per se categorisation) or may ask to be treated as a more sophisticated counterparty/client (resulting in less regulatory protection but potentially enabling access to a wider range of products or services) subject to meeting further criteria set out in MiFID II (elective categorisation).

consequence, ESMA stressed that investment firms do not have to follow the MiFID II rules regarding retail or professional counterparties/clients[27] when pre-hedging.

6.1.2 Feedback to the call for evidence

161. Most respondents to the CFE observed that pre-hedging practices take place not only in relation to eligible counterparties but also in relation to 'professional clients'[28]. The responses also made clear that pre-hedging retail order flow is sporadic at most.

6.1.3 Conclusions

162. In line with the evidence gathered, ESMA concludes that any future guidance on pre-hedging should address the RFQs from both professional clients and eligible counterparties.

163. Three additional circumstances support this conclusion:

- first, investment firms are subject to fewer requirements[29] under MiFID II when transacting with eligible counterparties and professional clients. However, both categories remain "clients" under MiFID II and their relationship with the investment firm is subject to this Directive.

- in particular, investment firms remain subject to the obligation to set up organisational and administrative arrangements to address the conflicts of interest that may arise in their interaction with both professional clients and eligible counterparties [30].

- finally, investment firms, credit institutions, insurance companies and other financial institutions authorised or regulated under EU law or under the national law of a Member State may act either as "eligible counterparties"[31] or as "professional clients"[32].

[27] Provisions as Best Execution (Article 27 of MiFID II), Counterparty/client Order Handling (Article 28 of MiFID II) are not applied when dealing with ECPs. Hence ESMA does not consider such provisions for the purpose of this analysis.
[28] Article 4(1)(10) and Annex II of MiFID II.
[29] In particular, Articles 24(4)(c) [information about costs and charges] and Article 25(6) [provision of adequate records of the service provided in a durable medium] do not apply to professional clients. And eligible counterparties do not benefit from the obligations set out in Article 24 [general information and information to clients]; Article 25 [assessment of the suitability and appropriateness and reporting to clients]; Article 27 [obligation to execute orders on terms most favourable to clients] and Article 28(1) [client order handling rules].
[30] Article 16(3) and 23 of MiFID II
[31] Article 30(2) of MiFID II
[32] Annex II of MiFID II

6.2 Conflicts of interest

6.2.1 Background

164. Investment firms should take all the reasonable steps to prevent conflicts of interest which might affect the interest of the firm's clients, in accordance with Article 16(3) of MiFID II. In particular, they must take measures to identify and prevent or manage conflicts of interest which may arise between themselves and their clients[33].

165. Two of the most important elements that investment firms should consider when identifying conflicts of interest are:

- when the firm itself is likely to make a financial gain at the expense of the client[34]; and

- when the firm itself has an interest in the outcome of a service provided to the client, which is distinct from the client's interest[35].

166. Therefore, firms are expected to establish, implement, and maintain a conflicts of interest policy set out in writing[36]. Where these arrangements are not sufficient to prevent the risks of damage to the interests of the client and where such risks cannot be alleviated by taking further or other measures, investment firms should disclose the conflicts of interest to their clients, enabling the client to make an informed decision with respect to the activity in question[37].

167. Furthermore, investment firms must maintain and update a record of the types of investment or ancillary service or investment activity in which a conflict of interest which might damage one or more clients has arisen or may arise[38].

168. ESMA asked market participants whether investment firms' conflicts of interest policies should specifically address pre-hedging. ESMA also consulted whether investment firms disclose to clients that their RFQs might be pre-hedged. Finally, ESMA consulted market participants whether investment firms offered quotes with and without pre-hedging to their clients.

[33] Article 23 MiFID II
[34] Article 33(a) of Delegated Regulation (EU) 2017/565
[35] Articles 33(c), (d) and (e) specify other scenarios in which conflict of interest might arise, as cases where the firm has a financial or other incentive to favour the interest of another counterparty/client or group of counterparty/clients over the interests of the counterparty/client, the firm carries on the same business as the counterparty/client or the firm will receive from a person other than the counterparty/client an inducement in relation to a service provided to the counterparty/client, in the form of monetary or non-monetary benefits or services.
[36] Article 34 of Delegated Regulation 2017/565 specifies further details on which aspects should be included in such policies, and further clarifies that the COIs policy should be periodically reviewed and updated if needed.
[37] Article 23(2) of MiFID II and Article 34(4) of Delegated Regulation 2017/565
[38] Article 35 of Delegated Regulation 2017/565.

6.2.2 Feedback to the call for evidence

169. Most of the respondents recognised that their internal procedures addressed pre-hedging as a possible source of conflicts of interest. However, only one response provided some clarity about the content of the procedure, referring to control of information, the need-to-know principle, segregated desks, record-keeping, and surveillance.

170. A large majority of respondents could not identify a common market practice in relation to the disclosure of pre-hedging to clients, which can take place through the terms of reference of a contract, in the course of bilateral discussions or electronically via email/chat. The responses also reiterated that providing case-by-case consent in electronic markets would be complex, if not impossible (see section 5.2.3.2).

171. Finally, the respondents to the CFE made clear that it is not a common practice to offer quotes to clients with and without pre-hedging.

6.2.3 Conclusions

172. Some stakeholders highlighted in their responses that they are present in financial markets without pre-hedging foreseeable transactions. Moreover, ESMA notes the existence of regulatory means to protect the interests of liquidity providers, such as the MiFIR pre-trade transparency waivers and the post-trade transparency deferrals.

173. At the same time, ESMA acknowledges that some of the arguments presented above against pre-hedging, including possible abusive behaviour or exploitation of the conflicts of interest, cannot be disregarded.

174. In light of these considerations, ESMA concludes that pre-hedging is a voluntary market practice which entails a risk of conflicts of interest between the investment firm and the client/counterparty.

175. As a consequence, ESMA considers that any future guidance in this area could contemplate the obligation of investment firms to explicitly incorporate pre-hedging in their conflicts of interest policy.

6.3 Other topics addressed in the CFE

6.3.1 Background

176. ESMA discussed in the CFE possible abusive practices which could be undertaken by those requesting quotes, e.g. a large RFQ could be used to obtain a benefit from the subsequent liquidity provider's pre-hedging.

177. Taking that into account, ESMA noted the investment firms' obligation to provide clear and not misleading information to eligible counterparties and asked market participants whether they would like to highlight any specific issue.

178. ESMA also analysed the possible interaction between pre-hedging, systematic internalisers and OTFs in the CFE.

179. Systematic internalisers are investment firms which, on an organised, frequent, systematic and substantial basis, deal on own account when executing client orders outside a regulated market, an MTF or an OTF without operating a multilateral system[39].

180. OTFs are multilateral systems which are not regulated markets or MTFs and in which multiple third-party buying and selling interests in bonds, structured finance products, emission allowances or derivatives are able to interact in the system, where the OTF operator executes the orders on a discretionary basis[40].

181. Systematic internalisers cannot operate any system that would "*bring together third party buying and selling interests in functionally the same way as a trading venue*"[41], since their trading activity is characterised by risk-facing transactions that impact the Profit and Loss account of the firm[42].

182. In line with that, ESMA considered that pre-hedging takes place by means of transactions that are exceptional by nature and cannot be used to circumvent the requirements stemming from MiFID II.

183. Investment firms operating OTFs are also subject to specific limitations regarding the execution of orders against their own proprietary capital[43] and cannot connect to any systematic internaliser[44]. Again, ESMA was of the view that the possibility to pre-hedge cannot be used to circumvent those requirements.

6.3.2 Feedback to the call for evidence

184. In relation to the possible abusive practices that could be undertaken in the context of pre-hedging, ESMA received a limited number of responses to this question and no additional points were identified on this issue.

[39] Article 4(1)(20) of the Markets in Financial Instruments Directive and Articles 12 to 17 of Commission Delegated Regulation 2017/565 on the organisational requirements of investment firms.
[40] Article 4(1)(23) and 20(6) of MiFID II.
[41] Recital 19 of Commission Delegated Regulation (EU) 2017/565 on organisational requirements for investment firms.
[42] See Q&As 26 and 27 of ESMA Q&As on MiFID and MiFIR market structures topics available in https://www.esma.europa.eu/press-news/esma-news/esma-updates-qas-mifid-ii-and-mifir-market-structures-topics.
[43] Article 20(1), (2) and (3) of MiFID II.
[44] Article 20(4) of MiFID II.

185. ESMA also received very limited feedback on the question regarding systematic internalisers and OTFs:

- two associations disagreed with ESMA's assessment that pre-hedging transactions should be exceptional by nature in the case of systematic internalisers;

- two other stakeholders reiterated the view that ESMA's guidance should not be focused on electronic competitive RFQ systems, but it should be applicable to other trading systems (systematic internalisers and OTC);

- one response suggested aligning ESMA's guidance with the GFXC.

6.3.3 Conclusions

186. The feedback received is too limited to inform an ESMA position in these areas.

7 Annex: feedback statement

QUESTION 1

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.

Generally, respondents included in their answers to this question general views on how pre hedging should be conducted or on what they believe legitimate and what illegitimated in the context of pre-hedging. Some of the points raised refer to:

- the importance of distinguishing front running from pre-hedging and ensure a robust framework is in place for pre-hedging;
- guidance on pre-hedging should be based on a case-by-case approach;
- the discussion on pre-hedging should be limited to the RFQ market model, because this seems to be the only instance in which market participants have raised concerns. Any further regulation imposed to financial markets, might have negative impact on liquidity and ESMA should be mindful if providing additional guidance on pre-hedging;
- one respondent provides some principles that should apply when conducting pre hedging and explains why pre-hedging should not be allowed (according to such principles) in the context of competitive automated/ electronic RFQs, while could be allowed (in some circumstances) in competitive voice and chat RFQs and bilateral voice and chat RFQs;
- pre-hedging is an essential element in financial markets for the provision of liquidity.

Three respondents do not provide a specific answer to the question.

Six respondents seem to overall agree with the definition of pre-hedging provided by ESMA. Three of them suggest specifying further case (ii) taking into account the two following scenarios:

1) situations where a client has submitted a “trade proposal”, but the trade will be agreed and executed at a later stage (in the case of a *benchmark order*),
2) cases where the trade has been agreed, but some elements of the trade will be specified at a later stage (in the case of an *at-best order*).

In relation to the above cases one respondent argues that pre-hedging of benchmark orders *may* be in the client's interest, or the interest of all market participants, as some benchmark orders, due to size and liquidity considerations, are not viable to execute within the specified timeframe of the benchmark. As an example, execution of large fixing orders within the fixing window, may lead to a price movement that is detrimental to the client's final fill rate, and may disrupt the functioning of the market.

On the other hand, the respondent also states that in his view pre-hedging of an at-best order would not make sense, if it implies that the dealer is trading in the market ahead of the client order coming into effect.

Several respondents remark that it is crucial that the definition of pre-hedging does not include *all* trading activities in the instrument or related instruments, during the time the order/RFQ is known/on-going. The activities that should be classified as pre-hedging should only be related to activities that are in fact originating from the knowledge of the order.

Some respondents only partly agree with the definition provided.

Five respondents overall argue that case (ii) would not qualify as pre hedging if there is a certainty to deal with the client and the price is the only variable to be determined. One respondent notes that in cases where the size of the transaction is not known then this could be considered a case of pre-hedging transactions.

Several respondents in this context stress that for the activity to be pre-hedging there should be a component of unknow risk stemming from the potential trade, otherwise the activity should be considered as hedging. They argue that such unknown risk to be hedged should be part of the definition.

Three respondents note that in their view case (i) could potentially qualify as pre-hedging, but more likely could pose tangible risks for the market in terms of market abuse. One respondent states that for case (i) to qualify as legitimate pre-hedging it is necessary to evaluate the levels of competition for the order; the transparency to the underlying client; and the likelihood of the liquidity provider actually assuming the risk. In the respondents view case (ii) represents indeed a legitimate case of pre-hedging.

One respondent states that in case (i) the activity should be considered as pre-hedging in instances where a client discusses the possibility of arranging a trade with a dealer but has not yet launched an RFQ. Such a situation may give rise to the dealer to undertake pre-hedging whether for legitimate or illegitimate purposes. The respondent does not consider case (ii) as pre-hedging.

One respondent argues that the rationale for pre-hedging (independently if the practice might or not be legitimate) cannot be demonstrated, hence it does not seem meaningful to include in the definition of pre-hedging the rationale for which the liquidity provider is undertaking the trade (i.e. possible benefit to the client).

One respondent argues that the definition provided focusses on trade-level pre hedging while often pre-hedging is conducted at portfolio level. Hence the definition should be reviewed.

One respondent states that they support the current FX Global Code definition of pre-hedging.

QUESTION 2

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

Ten respondents state that they do not think it is necessary to add any other market practice to the definitions. Two of these respondents do not suggest including further market practices, but state that it is important to define at which stage of a deal pre-hedging can be conducted.

Two respondents do not disagree with ESMA' s proposed definition but provide a series of scenarios and market practices which he thinks should be considered as legitimate pre-hedging. Among those:

Two of these respondents also stress that any definition/ guidance provided on pre hedging should not be limited to a specific trading model (e.g. RFQ) but rather technology neutral. More specifically one respondent states that the definition of pre-hedging should incorporate any scenario whereby two counterparties interact with each other to discuss a potential trade which may or may not include an RFQ. Additionally, one respondent notes in this respect that there are several scenarios in which one market participant may disclose their interest in a financial instrument selectively to another market participant or a limited set of market participants, in addition to RFQ. More specifically he points out that a market participant can: 1) bilaterally request a quote from another market participant (e.g. a buy-side client bilaterally requests a quote from their salesperson at a sell-side firm, perhaps an SI) or 2) sends an order to an interdealer broker. Who can possibly operate trading venues (typically OTFs) which are likely to be designed as voice trading systems, or at least not as an RFQ trading system. One respondent suggests that in his view the definition should encompass cases where only a single market maker for a particular product is in the orderbook and such market maker widens the spread after receiving an RFQ.

One participant states that he is in favour of a definition of pre-hedging, however such definition should be very well developed not to encompass other market practices. Especially with respect to ‘front-running’.

One respondent states that for FX they are in favour of the definition in the FX global code.

One respondent suggests including in the definition of pre-hedging the case of „quasi negotiations" intended as a situation where a client informs a dealer that in a particular date will need to make a transaction (e.g. 1 bln EUR) and the dealer provides part of the currency form the market and part will give from the own limit.

(i) Where following a request for a price from a counterparty there is an agreed understanding with the counterparty, the market participant agrees with the counterparty to trade at a stated reference price on the basis that the market participant is allowed to hedge in advance of the calculation of that price.

(ii) Where following an agreed understanding with a counterparty the market participant indicates that he will trade at a particular price or better if they are allowed to pre-hedge.

(iii) Where a third country exchange permits pre-hedging.

(iv) Where following the receipt of an RFQ the market: 1) is free to trade notwithstanding the fact that the trade may not be public as yet, 2) can widen his quote or pull his quote to protect themselves against persons who may misuse the information, 3) when a market maker is notified that the order has been filled elsewhere the market maker is free to update his prices to reflect the information even though that trade may not have been published, 4) when a reasonable period of time has passed by such that the counterparty has had a reasonable opportunity to execute the order the market maker is free to update their prices to reflect the information, 5) receives a RFQ with the opposite direction to the first RFQ, and may improve its price for the second RFQ and may deal whilst having knowledge of the first RFQ.

QUESTION 3

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

Ten respondents agree or mostly agree with the proposed distinction.

Two respondents agree with the definition, but states that case (ii) should be considered in nature as hedging.

One respondent believes that in some cases hedging (as opposed to pre-hedging) may be undertaken before the order has been confirmed by the client or a foreseeable transaction has been executed.

Three respondents do not agree with ESMA definition of hedging stating that:

i) In cases where the price is known even if the trade is not finalised the situation should be considered hedging.

ii) 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.

iii) One respondent explains that in his view the term "pre-hedging" is jargon, not used in all the jurisdictions. Instead, he explains that "hedging" is generally understood as a practice of (fully or in part) neutralising a risk position by entering into a position/contract which has an adverse risk/return characteristic and thereby offsets the original risk. However, entering in a position in an "anticipatory" or "forward looking" way very often is also based on the rationale to avoid a future risk which is likely to occur (but is still unknown and therefore only can be anticipated in an approximative way).

One respondent believes that drawing a definition of hedging and pre-hedging is a non-meaningful exercise.

One respondent believes that for FX, the FX code definition should be used.

QUESTION 4

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'?

Overall respondents have diverse opinion on last look practices, where:

- some believe last look is a practice that takes place mostly in the FX market and it is somehow regulated by the global FX code;
- some believe that last look practices are important for smooth liquidity provision;
- some believe that last look practices should not always be seen as legitimate;
- some believe that the practice is problematic, but nevertheless not specifically in relation to pre-hedging.

One participant notes that there should not be pre-hedging during last look windows, but the large majority of respondents seem to believe that last look should not be included in the analysis of pre-hedging.

QUESTION 5

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

Respondents have mixed views on the arguments in favour and against pre-hedging.

Those generally in favour of pre-hedging (8, mainly financial markets, banking or other type of associations) argued that that:

- the arguments in favour set in out in the CFE are valid and emphasized the benefit that pre-hedging brings by enabling liquidity providers to provide quotes in less liquid markets. Similarly, they also added that pre-hedging enables the execution of orders (especially large orders) that would otherwise be unable to receive a price.

- they disagree that there is no clear risk management rationale in liquid markets as market liquidity can change quicky and that it is not helpful to separate out pre-hedging by 'market type'. They considered that pre-hedging is legitimate in liquid and non-liquid markets where there is a risk management rationale.

- those respondents also highlighted that the CFE is not accurate as pre-hedging does not deteriorate the price offered to clients but on the contrary improves the final price received. Indeed, they noted that price without pre-hedging would be likely to include a markup aimed at covering the risk of not having sufficient visibility.

- other than being vital to ensure liquidity in the financial markets, pre-hedging is a tool for a bank or investment firm to effectively manage risk (some transactions would not be to conduct unless it is possible to pre-hedge this risk, such as bond issuances and M&A transactions, etc).

Respondents against pre-hedging provided the following views:

- One proprietary trading firm considered that in electronic RFQ markets, pre-hedging is unnecessary as there is no genuine risk management rationale and pricing should be firm and known to all market participants as soon as possible.

- One trading venue considered that pre-hedging should generally be banned and that it should only take place under very strict circumstances (i.e. either the deal is agreed, or "last look" approval from the requester is pending, or client is well informed). The same respondent considered that there is more risk of abusive behaviours when pre-hedging in illiquid markets as those markets are more likely to be impacted from pre-hedging activities (e.g. price movements to the detriment of the customers).

- One association considered that pre-hedging in competitive RFQ markets compromises market integrity, irrespective of RFQs trading protocol used (automated/electronic, chat or voice). Another drawback of pre-hedging is that there may be information leakage during the RFQ process, this could increase price slippage costs for investors. At the same time, the respondent also reiterated the concept of self-fulfilling prophecy where only one market maker pre-hedges in case of competitive RFQs.

The same respondent also included an additional argument against pre-hedging which appears in the CBOE rule 5.86(e). Similarly, the respondent considered that FINRA Rule 5270 should not be read as an argument in favour of pre-hedging as defined by ESMA but rather an exception in given circumstances. Same goes for the Canadian Universal Market Integrity Rules IIROC Rule 4.1. Its views were echoed by two other stakeholders.

These three respondents also mentioned that there may be an argument in favour of pre-hedging in case of the fixed income market, often based on bilateral negotiations while it is impossible in electronic RFQ markets to make such consent on a trade-by-trade basis and therefore pre-hedging is not appropriate (same for any market where multiple liquidity providers are in competition to win a trade).

Respondents argued that another point not mentioned by ESMA is that in large transaction volumes and high levels of automation of electronic RFQ protocols likely mean it is not possible for liquidity providers to ensure any pre-hedging is conducted with full counterparty transparency and understanding.

Finally, a couple of stakeholders (4, two associations, one trading venue and one trading firm) provided views both in favour and against pre-hedging in their responses:

- One fund association considered that pre-hedging is detrimental for competitive RFQs when there is no certainty of winning the trade (e.g. RFQs for ETFs). However, it also mentioned that pre-hedging can indeed result in lower bid-offer spreads for clients and therefore the focus should be on the client's benefit.

- One financial markets association considered that pre-hedging is likely to facilitate trading in markets where it is not always simple to readily see prices. However, liquidity should not be seen as the main and single criteria for the legitimation of pre-hedging. It was mentioned that ESMA should identify potential types of drawbacks and benefits of pre-hedging in the particular case of constellations as well as cases where pre-hedging has negative consequences for the market, as well as to propose mitigation measures that support positive outcomes.

- One trading firm considered that it depends on the nature of pre-hedging: where it consists in merely trading in the underlying in comparable size to the RFQ and in the same direction, it should be identified as front-running, whilst, where some more sophisticated risk-management regime is employed, it is possible that pre-hedging can be justified from a risk-management perspective.

A couple of respondents reiterated their general message on pre-hedging and did not focus exclusively on the arguments in favour and against.

Finally, two stakeholders suggested to ESMA to coordinate efforts at international (with US, UK, etc) in order to provide a level playing field in different jurisdictions

QUESTION 6

The majority of respondents did not simply focus on the question but provided their view on whether RFQs meet the definition of inside information.

The majority of respondents (7, mainly financial markets and trade associations and one trading venue) disagreed with considering RFQs as inside information on a systematic basis but stated that:

- a case-by-case assessment would be needed;

- what is proposed in the CFE is not consistent with the overall MAR approach and that, if a conclusion were to be reached that RFQs were routinely considered inside information, this would represent a huge shift in position for the industry and would result in significant market disruption. They noted that assimilating RFQs to inside information would constitute a significant change to MAR framework, that would deserve thorough assessment and market consultation.

- no additional guidance is needed on whether an RFQ can amount to inside information as the MAR framework is already comprehensive on what amounts to inside information and what is 'foreseeable'.

One of those respondents also mentioned that RFQs are generally non precise enough and as opposed to orders, lack the element of preciseness. The same stakeholder also mentioned 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.

On the contrary, two respondents (one principal trader association and one trading firm) agreed with ESMA's approach.

Other respondents focussed on more precise elements:

- One trading venue considered that the information has to be precise (containing instrument, buy or sell, quantity) and the liquidity of the market as well as the time of execution (e.g. outside of main trading hours) are crucial for the assessment of price impact.

- One association considered that one-way quotes are indeed precise but that also RFM can move the market as the direction of trade is not that relevant for assessing the price impact. This was echoed by another respondent which considered that both RFQs and RFMs contain information relevant to likely price movement subject to the foreseeable transaction. On the opposite, one association considered that RFM are not precise enough as an order must be placed before the information can be considered as sufficiently precise.

- One association noted that a foreseeable transaction may allow conclusions to be drawn about its impact on prices in the case of transactions concluded in markets or instruments with relatively low liquidity.

- One respondent (association), who generally disagreed with categorizing RFQs as inside information, mentioned that the impact of foreseeable transactions would be higher in the event the intermediary were not allowed to pre-hedge its risk.

- One trading firm considered that factors that would impact the ability for a conclusion to be drawn include its size, direction of the RFQ, the liquidity of the instrument, and the publicity of RFQ. However, they also mentioned that ESMA should not draw a distinction on this basis to determine whether pre-hedging is appropriate or not as in their view pre-hedging should not be permitted in case of competitive RFQ context in all cases.

Two respondents argued that it is difficult to respond as there are too many variables to be considered.

QUESTION 7

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?

Respondents have mixed views on whether RFM, when the liquidity provider could discover the trading intention on the basis of other factors, should be considered as precise information.

Four respondents (one trading venue, one trading firm, two funds' associations) agree. One of them considered that where the liquidity provider who is in receipt of an RFM can determine the likely side of the forthcoming transaction the RFM should be regarded as "precise information". The trading venue mentioned that liquidity providers will always know which way clients are trading, even if they ask for a two-way price.

Another stakeholder, while agreeing in principle, considered that is not relevant as ESMA should look to implement a simple, understandable approach by clarifying that pre-hedging in the competitive RFQ context should not be permitted.

However, the majority of respondents (11, mainly financial markets and other types of associations) did not agree as they considered that there is not enough certainty as to the direction of the trade in order for the liquidity provider to act with any degree of precision. These respondents reiterated that a case-by-case assessment would be necessary in such cases.

In addition:

- One respondent agreed that factors such as the past commercial relationship and market conditions (in particular the liquidity of the instrument) could help in guessing the intention of the requestor but argued that this would need an ad-hoc and comprehensive assessment.

- Two respondents warned ESMA against creating open ended regulatory definitions with concepts such as “past commercial relationships” as this could cause legal uncertainty. The same stakeholders suggested ESMA to considered that when a party (such as an inter-dealer broker) is just seeking information for the purposes of conveying pricing to another party, this is not inside information as this should be looked at as “polling”.

- One respondent stressed that by no means could news flow be considered precise information.

- Few respondents argued that ‘past commercial relationships’ might not be indicative for future intentions. To that end, one pointed out that RFQs are regularly sent out to multiple parties and there is no transparency on the past and current competition. Therefore, it was mentioned that it is unclear whether the current situation differs from the past and whether past winning/losing the quote probabilities are reasonable for the future.

QUESTION 8

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?

Respondents generally agreed with the criteria suggested by ESMA in the CFE. In particular, there was general agreement on the fact that important elements are the size of the RFQ, together with market liquidity, type of financial instruments, relevant news on the market, time of the day, etc. One respondent clarified that in its view the size is relevant but not the most important one.

However, some respondents (6, mainly associations and one trading venue) emphasized that a case-by-case assessment is necessary to assess the price impact of the RFQ. Indeed, some of the factors mentioned above vary from day to day, and sometimes intraday. The same respondents were strongly against the creation of an exhaustive list by ESMA of criteria that could potentially have a significant impact on price. They mentioned that this would be problematic and would not take into account the dynamics of different types of instruments, instruments and markets. They considered this to be extremely complex and inefficient as MAR already places an obligation on market participants to make such an assessment on a case-by-case basis.

On a separate note, one association noted that FINRA rule on block trades and FMSB Standards on large trades in FICC markets are not directly comparable when considering RFQs generally as they provide a framework for large trades only, rather than pre-hedging generally.

On the contrary, one trading venue considered that, not only the criteria that should be taken into account should be fixed, but a concrete threshold per criterion should be developed.

One exchange association provided a more general comment saying that there are several scenarios in which one market participant may disclose their interest in a financial instrument to other market participants in addition to RFQs. It was said that if the focus remains solely on activity on trading venues operating RFQ trading systems rather than more broadly on the activity of one market participant disclosing their interest in a financial instrument selectively to a limited set of market participants, ESMA risks adopting a scope which is too narrow for its guidance i.e. risk of unlevel playing field between RFQ trading venue and OTC and SI trading.

Finally, one respondent reiterated its view that pre-hedging should be banned in all competitive electronic RFQs.

QUESTION 9

Almost half of the respondents recognised the GFXC guidance to be a good starting point to identify cases of risk management that could justify pre-hedging.

In this group, few answers stressed a risk management rationale can exist only when the trader acts as a principal . Few respondents also expressed disfavour for an exhaustive listing of legitimate pre-hedging cases, as each conduct should be evaluated on a case by case basis.

With respect to the GFXC guidance specifically, some of these respondents pointed out

- GFX guidance is focused on a specific market and therefore cannot be exhaustive. FICC standards, as well as FMSB standards should be taken into account . However, due to the different functioning of markets a "no one-size fits all approach", should be adopted and an in-depth analysis of different practices and functioning of RFQ process should be undertaken

- GFX guidance is not binding guidance and

- Compliance with the principles stated therein is difficult to prove.

One respondent indicated further criteria that should be taken into account in order for pre hedging to be deemed legitimate. More specifically, pre-hedging could be legitimate

(i) If it reduces the risk on one's book, or

(ii) where the responder has hit/lifted requester quotes and the LP expects the "last look" approval from the requester/ client that is pending, or

(iii) where final exchange validations for an ETD is pending.

Two respondents also pointed out there are additional cases of pre-hedging . For example, where a liquidity provider is requested to give quotes to a multiple number of clients, and to the Interbank market, he may take more risk than what he is willing to accept. In this case, the liquidity provider is not necessarily doing actual trades, but he may nevertheless affect the general price formation in the market.

Respondents against the adoption of the criteria indicated, argued such criteria consider only the benefit of the liquidity providers and do not take into considerations unfavourable outcomes for clients, or competition in general. In particular, one answer warned the practice described under (a), (b) and (c) may cause disadvantage for clients and result in poorer quoted prices. Thus, this group recommended regulators to take into account the impacts of the practice on the wider market.

QUESTION 10

Most of the respondents (8) were not able to provide examples of pre-hedging practices with/without a risk management rationale.

On the issue, however, few respondents indicated that the risk management rationale is inherent to pre-hedging and that pre-hedging practices are generally not carried out without a risk management rationale. Furthermore, where pre-hedging is without a risk management rationale it could be a form of market abuse (i.e. frontrunning).

On this basis, one respondent from this group suggested the inclusion of the risk management rationale in the pre-hedging definition.

Some respondents indicated practical examples of pre-hedging with a risk management rationale are very case and fact specific instances which differ from market to market. Similarly, one respondent indicated it is not possible to identify abstract examples and supported the need to carry out a case by case assessment.

Always taking into consideration specific cases, one respondent warned a “proactive” inventory management can have also non directly (market) risk-management related reasons. This could be for example the case of “lot-size transformation” which aim to reduce transaction costs or to ensure the facilitation of settlement and to avoid fails in less liquid securities, where it would be difficult/insecure to find sufficient liquidity to fill a delivery obligation “ex post”.

Another respondent indicated that in the electronic RFQ markets there is only a legitimate risk management rationale for pre-hedging where the liquidity provider has assumed the risk of the trade.

In addition, one answer pointed out to the scenario outlined in the response to Q9.

Two respondents referred to their answers provided to Q2.

Lastly, few respondents took the opportunity to stress pre-hedging can favour the client, as it permits better pricing.

QUESTION 11

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?

The great majority of respondents (16 out of 18) excluded very clearly pre-hedging can be legitimate when the market participant is aware, on the basis of objective circumstances, that he will not be awarded the transaction. Some added to their answers that in such a case pre-hedging would be front-running and thus, should be illegitimate.

Many respondents warned it is however difficult to identify ex-ante circumstances able to suggest a transaction will be/ or will not be concluded as the context of each transaction is different, so a case by case assessment would be necessary to this aim. Furthermore, even then the assessment of probability to conclude a transaction would be difficult.

On this basis, one respondent indicated that the GFXC principle 11 refers to “reasonable expectation” of the transaction to be won. Thus, he suggested to exclude pre-hedging is legitimate when the liquidity provider “cannot reasonably assume” to win the transaction. On the same point one respondent indicated in its view it is impossible for a trader to have such expectation.

Another respondent indicated that only under strong objective reasons to conclude the transactions - which are unlikely to occur - pre-hedging could be legitimate.

Taking into consideration the single circumstances, one respondent indicated that the distance between the quote and the market is not a reliable indicator, especially for market makers as it is their role to define the market position.

Another respondent indicated the market shares in a particular product or having 1 out of 3 chances to win the transaction would not be good indicators either. This is because such indicators would permit only established liquid providers to pre-hedge, whilst excluding pre-hedging for other market players who do not meet such conditions, harming ultimately competition.

One respondent noted that if a firm would not be likely to win the transaction, it would not provide a quote at all.

QUESTION 12

Can you identify financial instruments that should/should not be used for pre-hedging purposes? Please elaborate

There is general consensus among respondents that all financial instruments can be used to pre hedge.

In this respect, few respondents (2) stressed the choice of the financial instruments used for pre-hedging occurs on a case-by-case basis. Some others remarked pre-hedging may involve the same instruments subject of an RFQ, derivatives of these instrument or different instruments entirely. One respondent in the same vein, highlighted only no correlated instrument can be excluded for pre-hedging purposes.

Respondents favourable to pre-hedging stressed in their answers no instrument should be banned or excluded a priori, especially where steps have been taken to avoid conflict of interest or prevent price impact or where more generally pre-hedging reflects legitimate purposes or is conducted under monitor and control by the dealer.

One respondent indicated pre-hedging could be beneficial especially for less liquid instruments (e.g. less liquid options markets). Another pointed out 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.

A small group of respondents against pre-hedging, indicated the prohibition should interest trading in the financial instrument to which the order relates and any related financial instruments. For example, a recipient of a price request in an ETF based on the DAX index should be precluded from trading in the ETF itself and the underlying constituents.

Only one respondent distinguished between instruments that could be used for pre-hedging and not. In particular, they indicated that pre-hedging can be performed through: currency derivatives (FWD, options, also SPOT etc.), or the interest rate, bonds (including BSB/SBB / repo / rev repo), but not instruments of the regulated market (shares, stock contracts etc.).

QUESTION 13

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

Few respondents (3) expressly shown support to use as indicators to identify legitimate pre-hedging practices: (i) the risk management purpose; (ii) the quality of principal of the trader; (iii) likelihood of the transaction going ahead and (iv) the interest of the client. Two of these respondents indicated liquidity can be taken into consideration, for example to demonstrate the client benefit but it should not be prescriptive.

One respondent stressed the importance of adopting a case-by-case approach in determining transaction legitimacy, and on this ground, he recommended that any list of indicators should be non-exhaustive and non-binding.

Taking into consideration the single indicators many respondents commented on the interest of the client.

In this respect, one respondent noted this element may be difficult to identify but could appear 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.

Another respondent indicated the aim to comply with the best execution rules reflects the pursuit of the interest of the client. In this respect, he brought as good example of legitimate pre-hedging practices trading, which is used to calculate reference prices where clients, especially funds, seek exposure to prices which are as close as possible to a reference price in a particular instrument (e.g. for portfolio valuation purposes).

Few respondents suggested to adopt as an indicator for the interest of the client the “adequate client disclosure” and/or consent.

With respect to this indicator different points were made

- One respondent deemed consent of the client to be absolutely necessary to consider pre-hedging legitimate, and indicated such approval is always possible.

- Few respondents pointed out the absence of disclosure should not indicate illegitimacy and along the same line, the disclosure should not correspond to legitimacy .

- One respondent indicated the liquidity provider should share in advance with client evidence that the pre-hedging will not move the market against the client.

Taking into consideration the case (no. 3) where the transaction is in the interest of both the client and the liquidity provider, two respondents indicated that if by interest is meant “the financial interest” of the parties such case should not be considered legitimate. The same respondents indicated the improved risk management for the liquidity provider is difficult to quantify, as the cost of the transaction for the trader in case of not pre-hedging may not be calculated at all.

One respondent indicated that the FMSB standards under Principle 7 already provide a set of criteria to identify when pre-hedging practices are allowed (“*all cases where (i) the market maker has a legitimate expectation to take on market risk and pre-hedging is undertaken at its own risk; (ii) when the trading activity is reasonable relative to the size and nature of the anticipated transaction; (iii) when pre-hedging aims at minimising the impact of the activity on the market; and (iv) when this is designed to benefit the counterparty/client*”).

The same respondent also indicated the Global FX Code (July 2021), under the section “Controls and Disclosures around pre-hedging”, provides a list of procedure to undertake in order to fairly handle client orders. Consequently, in his view, pre-hedging activities which are compliant with the Code should be considered legitimate.

One respondent warned that the criteria indicated may not be met in the competitive environment, as in this context (i) there is no certainty to be awarded the transaction; and (ii) clients may receive a worse outcome from pre-hedging especially when multiple liquidity providers pre-hedge and (iii) transparency to clients and their consent to pre-hedging transactions cannot be provided effectively in automated, electronic RFQ protocols.

One respondent referred to his answer to Q2 above.

Another respondent considering pre hedging as legitimate per se, indicated to not consider any indicator useful.

QUESTION 14

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?

On the possibility to collect consent on a case-by-case basis answers were mixed.

Overall, there seems to be agreement on the fact consent can be always required outside the electronic context. One firm also indicated it is possible to obtain it through electronic channels, without any limits.

Two respondents indicated that consent can be obtained. However, this situation cannot be generalised and depends on the type of market, or the context in which the transaction takes place more generally. One answer specified for the FX market such request would be possible.

All respondents taking into consideration the electronic context (8) indicated express consent for each transaction is not feasible for such type of trading. One of these respondents, indicated in such context current best practices include a general disclosure of the pre-hedging practises, whereas ad hoc specific disclosure is foreseen only where necessary. Along the same line, two other respondents indicated disclosure to clients of the general practice is achievable for the electronic trades, for example through publication on the firm website, and one of them made reference to GFXC commentary on Principle 11 as basis for such practice.

One respondent only indicated consent is paramount for the legitimacy of the transaction, and that the client should be explicitly informed for each individual RFQ that the firm may pre-hedge, to enable disclosure on a trade-by -trade basis. At the same time, the same respondent recognised in the electronic context consent cannot be obtained for each transaction. Acknowledging the same obstacle, one respondent indicated to be nevertheless in support of request of express consent outside of the electronic consent on a trade-by-trade basis.

One respondent suggested ESMA to define communications standards to enable quick checks on communications occurred between the trader and its clients. The same respondent indicated at the same time the request for consent for each transaction would be a huge burden for the firm.

In respect to whether consent can ground a presumption of legitimacy of the liquidity provider behaviour, four respondents provided a positive answer, but some of them at the same time noted consent does not prevent any illegitimate behaviour from occurring. Thus, the presumption should be rebuttable.

Very few respondents (2) were openly against a presumption of legitimacy based on consent.

One stakeholder indicated that pre-hedging should be legitimate per se, thus no indicators are needed to identify legitimate practices. Another respondent indicated that the practices' legitimacy should exclusively be based on the risk mitigating effects of the transactions. Another remark made on the same line was that consent needs to be accompanied by other conditions, as it alone cannot justify the practice.

One respondent discouraged to introduce consent as a requirement to pre-hedge.

As a general remark, a firm indicated it is better to use the term on a "trade-by-trade" basis to be more precise, rather than on a "case-by-case" basis when referring to consent request.

QUESTION 15

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?

Most of the respondents took the opportunity to express their general opinion on the practice in terms of benefits for the clients, rather than providing examples of practices that clearly damage the clients.

The respondents (5) who provided examples pointed out in their answers mainly address the case where the trader knows that it cannot execute the transaction. Among this group, some answers specified this occurs when trading occurs in response to an RFQ without the intention to provide a quote (2), or in a way disproportionate to the quote, or more in general, without the aim to win the trade (1).

Taking into consideration answers which expressed favour or disfavour for pre-hedging practices more in general, the (6) respondents in favour to pre-hedging indicated benefit of pre-hedging practices for clients can always be demonstrated. In support of this argument one answer indicated pre-hedging always permits to provide a better price to the client, whereas another pointed out the practice is beneficial to the overall markets, as it reduces risk of firms' failures, and it should thus be evaluated independently from side effects on clients.

Along the same line, an additional respondent indicated that even if pre-hedging was not in the interest of the client, still it does not make a MAR infringement. Furthermore, one respondent - quoting Principle 11 of the FX Global Code - indicated pre-hedging by definition has always to be in the benefit of the client.

Taking the opposite stands, some firms (4) indicated pre-hedging is more likely to damage the client by moving the prices against him, rather than bringing any benefit.

QUESTION 16

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.

Seventeen stakeholders replied to the question regarding the feasibility of providing evidence of the reasonable expectation to conclude the transaction; the risk management needs and the benefit for the client behind the pre-hedging transactions and the client's consent.

The answers received could be grouped in two buckets:

- The vast majority of responses (10) considered that it would not be possible to provide such evidence, finding different arguments against such provision (the increased administrative burden would lead to a reduction of liquidity in certain markets; such evidence would be linked to the overall trading activity of the pre-hedging firm...). Most of these responses considered that the existing MiFID II and MAR record-keeping requirements adequately addressed the pre-hedging requirements.

- Five responses considered that liquidity providers should be able to provide that evidence (on an ex post basis). One of these market participants noted that the reasonable expectation to conclude a transaction is possible as long as there is a market on the financial instrument with a certain degree of liquidity. Some of these responses reiterated that such evidence could be built on the basis of the existing MiFID II and MAR record-keeping requirements, without need for additional requirements.

QUESTION 17

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.

The great majority of respondents seemed to consider that the liquidity of a financial instrument should not be considered as an indicator in determining whether pre-hedging may be illegitimate behaviour. In detail, those respondents (10) noted that:

- liquidity itself is not a sufficient criterion to consider the legitimacy of pre-hedging and it should be assessed on a case-by-case basis alongside with transaction size, type of financial instruments, relevant news on the market, bearing also in mind that such factors can evolve rapidly.

- pre-hedging is just as legitimate a practice in liquid markets as in illiquid ones, with liquidity providers still needing to manage risks by pre-hedging. Those respondents say that if pre-hedging were not permitted in liquid markets, this would have a detrimental impact on the ability of firms to effectively manage risk and consequently on the prices offered to client.

- the need of a firm to manage its risk is not solely dependent on the liquidity of a market (which is not binary – liquid / illiquid) and can change quickly intra-day or with the introduction of large orders or a large volume of orders.

- One respondent argued that hedging activities in liquid instruments are not less important from a risk management perspective.

- Another respondent considered that what should be assessed is the intention behind pre-hedging to provide a price to clients for their benefit. This is the main indicator against market abuse and not liquidity.

- Some of these respondents also brought forward that it is not easy to determine when a market is liquid / illiquid, also when using the MiFID definition. Liquidity of a given market can vary significantly on a day-to-day basis, and even intraday. This assessment is subject to both market and world events and pre-hedging can be just as legitimate in liquid markets as in illiquid ones (it reiterated that a case-by-case analysis is needed).

A couple of respondents had somewhat a less strong views while agreeing that liquidity should not be used as an indicator. They noted that liquidity of the financial instrument should not be the main consideration but rather the material market structure context in which the pre-hedging would occur i.e. pre-hedging in electronic RFQ markets is not justified whilst in markets where there are fewer dealers and where bilateral negotiation with a dealer is the execution method of choice, pre-hedging with the trade by trade consent of the client and under other conditions could reasonably be permitted.

On the other hand, a few respondents (3) considered that liquidity is indeed a relevant indicator to assess whether pre-hedging may be illegitimate behaviour.

QUESTION 18

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 received twelve responses to the question about the type of clients' orders that are pre-hedged.

The large majority of respondents state that pre-hedging takes place with respect to professional clients and ECPs.

One respondent stated that they did not have specific information on this matter and another respondent indicated that, in the FX market, such practices can be carried out when dealing with retail clients as well.

QUESTION 19

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 received ten responses to the question on whether pre-hedging is addressed in the COI policies and procedures.

The majority of respondents conclude that investment firms have in place policies and procedures to address COIs as per MiFID II requirements. Whereas some respondents explain that such policies specifically target pre-hedging, the rest refer to them in a more general manner.

No respondent elaborated in detail on the content. Two respondents did not provide an answer.

QUESTION 20

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 received twelve responses to the question regarding the current disclosure of pre-hedging practices.

Five responses noted that firms may inform about their pre-hedging practices through general disclosure in their terms of business or through 'ad hoc' disclosure in the course of bilateral discussions.

One association considered necessary to consent pre-hedging on a case-by-case basis. At the same time, that association noted that the pre-requisite for such consent was full transparency of pre-hedging practices. However, this association acknowledged the practical difficulties in electronic competitive RFQs, concluding that pre-hedging should not be permitted in those trading models.

Two other associations recommended that ESMA should deliver technology neutral guidance, not focusing on RFQ trading models.

Three responses recommended ESMA to follow the same approach as the GFXC regarding disclosures.

QUESTION 21

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 received ten responses when it asked whether clients are offered quotes with and without pre-hedging according to current market practice.

Nine of these responses indicated that it was not common practice. In the cases where it did happen it came at the express request of the client. Three of the stakeholders noted that such practice would not be possible in certain cases.

QUESTION 22

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 received nine responses to the question on whether firms currently record pre-hedging transactions and on whether record-keeping of these transactions would be easy to implement.

Almost all the respondents considered that the existing record-keeping obligations under MiFID II and MAR provide enough information on pre-hedging transactions. Only one firm reported storing pre-hedging transactions separately. Three stakeholders considered that imposing additional record-keeping obligations would be disproportionate.

Finally, one firm pointed out that pre-hedging a future transaction (as hedging a transaction) is not necessarily done through one-for-one transactions. That firm concluded that inventory risks are managed on a portfolio basis, taking into account all the trading desks of a firm.

QUESTION 23

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

ESMA received eight responses to the question about additional issues regarding the obligation to provide clear and not misleading information.

Most of the responses did not add anything else. Two stakeholders agreed with ESMA's view in relation to the likely existence of market abuse in case a large RFQ is used to obtain a benefit from the subsequent liquidity provider's pre-hedging.

QUESTION 24

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

ESMA received ten responses to the question about pre-hedging, systematic internalisers and OTFs.

Four of them did not have anything to add. Two associations disagreed with ESMA's view that pre-hedging transactions of SIs should be exceptional by nature.

Two stakeholders reiterated the request that future ESMA guidance should be technology-neutral, and not focused on electronic competitive RFQ systems.

One response suggested aligning ESMA's guidance with the GFXC.