ESMA Report on the Call for Evidence on pre-hedging

September 2023

On 12 July 2023, ESMA published a Report tackling the possible treatment deserved by pre-hedging practices, carried out by liquidity providers when trading financial instruments. For this, the document published analyses the responses received resulting from the Call for Evidence (CfE) launched in July 2022.In particular, ESMA studies two specific cases related to pre-hedging: (a) a liquidity provider trading, in the context of an RFQ (Request for Quote), ahead of the acceptance of a quote from the client; and (b) a liquidity provider trading ahead of a pending order.

As a starting point, ESMA commences with the definition of pre-hedging in the CfE, understanding this to be any trading activity undertaken by an investment firm (IF), where: (a) the IF deals on its own account; the trading activity is undertaken (b) with the aim of mitigating an inventory risk which is foreseen due to a possible incoming transaction (from clients), (c) before that foreseeable transaction has been executed, and (d) at least partially in the interest and benefit of the client or to facilitate the execution of possible incoming transactions.

The controversy regarding pre-hedging and its advantages

In the Report, ESMA refers to an academic paper[1] suggesting that certain pre-hedging practices might drive to a final price level that is less favourable to the clients. Specifically, it alludes to the conflict of interest in which the dealer may incur when pre-hedging derivative transactions through trading in underlying assets, in such a way the price of these transactions is more favourable to them and to the detriment of their clients.Some market participants argue that the possible risks of this practice could be more pronounced when clients request several competitive RFQs or in the case of RFQs in very liquid assets.

The responses to the CfE included arguments against pre-hedging, with a stakeholder even considering a form of front-running[2] in certain cases (particularly when trading similar volumes and in the same direction as those taking place in an RFQ). Likewise, other responses indicated that in competitive RFQ markets, pre-hedging compromises market integrity as it results in increased price slippage cost[3], apart from the fact it might create an uneven playing field when one liquidity provider pre-hedges while others do not. Finally, a new element of so-called ‘free-optionality’ emerged from the responses to the CfE, with the Report showing how a liquidity provider could shift its market risk to the client, without passing on the possible benefits[4].

However, in the opposite sense, the CfE already indicated that pre-hedging is a frequent practice in financial markets that is not banned in other jurisdictions[5] (provided that certain requirements are met). Along the same line, ESMA included in the document certain references to cross-border initiatives to tackle this practice[6] and to the factors under which it would be considered valid.

Similarly, the CfE includes arguments from market participants received for previous ESMA consultations[7] claiming that this practice achieves a market risk reduction, less volatility and lower costs in general, apart from better quotes offered to clients. The responses to the CfE in favour of pre-hedging reiterate that it enables the execution of large orders that would otherwise be complex to execute, apart from noting that it is a necessary tool for banks and investment firms to effectively manage their risk.

After considering the different arguments received both in favour and against after the CfE, ESMA concludes that pre-hedging is a voluntary market practice which might give rise to conflicts of interest or abusive behaviours, risks that should be taken into account when issuing any future guidance on is matter.

Along the same line, for its analysis ESMA has already considered FINRA Rule 5270 on how to act in the case of block trades (customer block orders)[8]. However, the Report highlights that it is still to study whether or not this rule covers the case of a liquidity provider pre-hedging ahead of the acceptance of a quote from the client.

Pre-hedging within the scope of the Market Abuse

Regulation (MAR)[9]

– RFQ as inside information

In the CfE, ESMA compiled certain evidence to assess whether an RFQ can be considered insider information, in accordance with the definition contained in Article 7(1)(a) MAR[10].

Also, the views of market participants were requested on whether buyer and seller quotes – two-way quote (also known as request-for-market or RFM) – could be considered precise information and constitute insider information.

In response to this, the arguments received from participants indicated that RFQs should not systematically be considered insider information (as such comparison would deviate from the current interpretation of MAR).

Therefore, ESMA acknowledges that a case-by-case assessment would be needed to decide whether an RFQ can be considered insider information and, where deemed appropriate, it is indicated that the case law of the Court of Justice of the EU on this matter will be taken into account[11].

– Indicators of legitimate and illegitimate behaviour under MAR

The CfE considers some parameters to evaluate the legitimacy of pre-hedging practices under MAR.

First, the position of the subjects regarding pre-hedging and the conclusion is reached that those agents not taking risks when concluding transactions (i.e., not negotiating for their own account), would have no reason to perform these practices. The feedback received shares this position.

Second, it is estimated that pre-hedging should also respond to risk management needs. In turn, this management will take into account, in the cases considered necessary for this purpose, the probability of execution of the transaction and the instruments used. The responses to the CfE show that market participants support a case-by-case assessment of the different practices and reference is made to the existing GFXC[12] and FMSB[13] guidance to be used as a good starting point to identify legitimate practices. However, there is a generalised consensus that the activity cannot be considered legitimate when there are no expectations of concluding the transaction. With regard to the instruments used for pre-hedging, it is agreed that any type of instrument related to an RFQ is valid as long as the pre-hedging is performed in relation to such RFQ. Likewise, the document suggests continuous case-by-case assessment on whether the use of highly diversified instruments can be considered an indicator of legitimate behaviour.

Third, the interest of the client is sought, while also whether the client’s express consent to pre-hedging implicitly confirms that interest. Although it would seem this could be used as an indicator, ESMA and the participants noted that consent alone does not prevent illegitimate behaviour from occurring. However, while a group of participants alludes in its responses to the permanent interest for the client by having better quotes or better execution, others consider that the price variations caused in the process are contrary to the interest of the client. Considering both positions, ESMA simply concludes that the interest of the client will be estimated from among the criteria considered in the case-by-case assessments.

– The liquidity of the instrument as an indicator of possible illegitimate behaviour

The majority of the responses included in ESMA's document indicate that the liquidity should not be generally considered as an indicator of illegitimate behaviour. It is highlighted that other factors should also be considered, such as the transaction size, the type of financial instrument and relevant news on the market. Along the same line, ESMA once again favours case-by-case assessments which should observe criteria/indicators, with liquidity among them, in order to monitor whether there is any illegitimate behaviour and, therefore, a negative impact on the client.

Pre-hedging and its implications regarding the Markets in Financial Instruments Directive and Regulation (MiFID II/MiFIR)[14]

– Type of clients impacted by pre-hedging

As is well known, MiFID considers types of client according to their experience and knowledge to adapt the investor protection corresponding to their profile. At first, ESMA observed that this activity basically takes place in wholesale markets, with IFs and eligible counterparties as the main players. However, the responses to the CfE inform that, although to a lesser extent, professional clients also participate in this activity (sporadically even retail clients). Accordingly, ESMA indicates that the guidance developed in this respect will cover not only the RFQs of eligible counterparties, but also those of professional clients.

– Conflicts of interest

MiFID II provides that IFs should identify and prevent or manage conflicts of interest that may arise between them and their clients in such a way they are not affected[15]. Specifically, when a benefit is obtained at the expense of the client and when the interests of the client and the provider are not aligned. For this, IFs will have a conflicts of interest policy set out in writing and additional measures to mitigate these risks, while they will also disclose the conflicts of interest to their clients whenever they cannot be prevented or alleviated.

On the one hand, most participants recognised in their responses to the CfE that their internal procedures addressed pre-hedging as a possible source of conflicts of interest, although only one response provided some clarity about the content of the procedure. On the other hand, the responses did not identify a common market practice in relation to the disclosure of pre-hedging to clients, not even in the terms of the contracts. Accordingly, ESMA considers that any future guidance will foreseeably contemplate the obligation of investment firms to explicitly incorporate references to pre-hedging in their conflicts of interest policy.

– Other considerations in the CFE

Finally, ESMA attempted to gather in the CfE the comments of market participants on the on the relationship between possible abusive practices undertaken by those requesting quotes and the obligation, stated in MiFID II, of IFs to provide clear and non-misleading information to eligible counterparties.

Furthermore, the consultation also included the possible interaction between pre-hedging, systematic internalisers (SIs) and organised trading facilities (OTFs).

Regarding both these questions, ESMA considers the feedback received is too limited to be able to reach a position. [1] 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).

[2] Irregular advantage taken by the dealer when not diligently executing an order upon receiving it, but performing trade in the same direction on his own account, to later place the assets with his client thus obtaining a risk-free spread.

[3] Difference in the price at which an order is executed with regard to the price at which is was placed.

[4] Specifically, the document indicates two situations than may occur when pre-hedging. The first case is when the pre-hedging gives rise to price movement in his favour and this benefit is not passed on to the client. The second case is when they modify the quote to cover themselves when they know the pre-hedging has caused a price modification that is unfavourable to them.

[5] Such as in the US (FINRA Rule 5270).

[6] Global FX Code (GFXC -Principle 11) and the Financial Markets Standard Board (FMSB) Standard for the execution of large trades in fixed income, currency and commodities (FICC).

[7] ESMA Public Consultation on the Market Abuse Regulation review.

[8] This rule prohibits any order form being placed in a security or financial instrument when the dealer has material and non-public market information concerning an imminent block transaction in that security or financial instrument (even if an underlying security) before the information is made public. As an exception, pre-hedging may be permitted to the dealer under the following conditions: (a) it facilitates the execution of the customer block order, minimizing potential disadvantages or harm; (b) its financial interests will never be placed ahead of those of the client; and (c) the customer's consent will be obtained before performing the transaction.

[9] Regulation (EU) No 596/2014 of the European Parliament and of the Council of 16 April 2014 on market abuse.

[10] "[…] Inside information shall mean information of a precise nature which has not been made public, relating, directly or indirectly, to one or more issuers of financial instruments or to one or more financial instruments and which, if it were made public, would be likely to have a significant effect on [11] the prices of those financial instruments or on the price of related derivative financial instruments. […]".

the decision of the Court of Justice of the EU (CJEU) in the case Lafonta vs. Autorite des Marches Financie (AMF), which concludes 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.

[12] Global Foreign Exchange Committee: Commentary on Principle 11 and the role of pre-hedging in today's FX landscape, July 2021.

[13] FICC Markets Standard Board: Standard for the execution of Large Trades in FICC markets, May 2021.

[14] Directive 2014/65/EU of the European Parliament and of the Council, of 15 May 2014, on markets in financial instruments / Regulation (EU) No 600/2014 of the European Parliament and of the Council, of 15 May 2014, on markets in financial instruments.

[15] Article 16(3) MiFID II.

Links of interest:

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