Response Form to the Call for evidence on pre-hedging

Responding to this paper

ESMA invites comments on all matters in this consultation paper and in particular on the specific questions. Comments are most helpful if they:

- respond to the question stated;
- indicate the specific question to which the comment relates;
- contain a clear rationale; and
- describe any alternatives ESMA should consider.

ESMA will consider all comments received by **30 September 2022.**

Instructions

In order to facilitate analysis of responses to the Consultation Paper, respondents are requested to follow the below steps when preparing and submitting their response:

1. Insert your responses to the questions in the Consultation Paper in the present response form.
2. Use this form and send your responses in Word format (**pdf documents will not be considered except for annexes**);
3. Please do not remove tags of the type <ESMA_QUESTION _PHDG_1>. Your response to each question has to be framed by the two tags corresponding to the question.
4. If you do not wish to respond to a given question, please do not delete it but simply leave the text “TYPE YOUR TEXT HERE” between the tags.
5. When you have drafted your response, name your response form according to the following convention: ESMA_PHDG_nameofrespondent_RESPONSEFORM. For example, for a respondent named ABCD, the response form would be entitled ESMA_PHDG_ABCD_RESPONSEFORM.
6. Upload the form containing your responses, **in Word format**, to ESMA’s website (www.esma.europa.eu under the heading “Your input – Open Consultations” -> Consultation Paper on the clearing and derivative trading obligations in view of the benchmark transition”).

Publication of responses

All contributions received will be published following the close of the consultation, unless you request otherwise. Please clearly and prominently indicate in your submission any part you do not wish to be publically disclosed. A standard confidentiality statement in an email message will not be treated as a request for non-disclosure. A confidential response may be requested from us in accordance with ESMA’s rules on access to documents. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by ESMA’s Board of Appeal and the European Ombudsman.

Data protection

Information on data protection can be found at www.esma.europa.eu under the heading Legal Notice.

Who should read this paper

All interested stakeholders are invited to respond to this call for evidence. This call for evidence is primarily of interest to investment firms, credit institutions, proprietary traders, market makers, asset management companies and in general persons operating on an ongoing basis in financial markets, but responses are also sought from any other market participants including trade associations and industry bodies, institutional and retail investors, consultants and academics.

General information about respondent

Name of the company / organisation	Foreign Exchange Professionals Association
Activity	Regulated markets/Exchanges/Trading Systems
Are you representing an association?	☒
Country/Region	International

Questions

Q1 Do you agree with the proposed definition of pre-hedging with respect to case (i) and (ii)? Please explain elaborating if both case (i) and case (ii) in your view can qualify as pre-hedging and providing specific examples on both instances.

<ESMA_QUESTION_PHDG_1>
The FXPA believes the proposed working definition of pre-hedging is too broad and should focus on trading activity undertaken by an investment firm where the investment firm is dealing on its own account and the trading activity takes place before that foreseeable transaction has been executed. The FXPA believes case (i) is appropriate within the context of a working definition of pre-hedging.

However, once an order is awarded at a determined price, the FXPA believes that a liquidity provider's trading activity to manage its risk should not be considered pre-hedging. This situation more closely aligns with case (ii) in the proposed definition, which the FXPA believes may be better classified as hedging, rather than pre-hedging, by the liquidity provider.

In addition, the FXPA encourages ESMA to consider adopting the definition and related scenarios set forth in Principle 11 of the Global FX Code, as well as in Annex 1 to Principle 11. The Global FX Code has closely looked at pre-hedging from both a regulatory and market participant perspective. The Global FX Code, the annex, and the July 2021 commentary on the role of pre-hedging in the FX market should inform ESMA's development of any pre-hedging framework. Global alignment of a definition for pre-hedging would help to harmonize global regulatory frameworks and to ensure a consistent approach to pre-hedging by market participants who have already relied on the Global FX Code definition.

The FXPA also believes that ESMA should recognize that clients have a choice regarding whether and how they transact with liquidity providers. Pre-hedging policies are disclosed to clients, and if they do not wish to engage with that liquidity provider, clients can decide to seek prices from another liquidity provider. The concept of client choice is not reflected in the Call for Evidence.

Finally, consistent with our assessments of case (i) and case (ii) above, the FXPA reiterates that pre-hedging should be identified for a relatively limited number of trades. The GFXC Commentary on Principle 11 suggests that pre-hedging activity "should be commensurate with the potential risk assumed by the liquidity provider from the anticipated order and the prevailing liquidity and market conditions for the specific currency pair. Factors that could be potentially considered in deciding whether pre-hedging could be used to manage the risk of an anticipated order, include whether the potential transaction is: (1) large relative to the liquidity provider's risk limits; (2) large relative to normally available market liquidity for the particular FX pairing; and (3) requested during a relatively illiquid time of day, or when general market conditions are otherwise illiquid". In other words, some discretion is needed when identifying pre-hedging, and a rigid one-size-fits-all approach to a working definition would be difficult to incorporate into market operations.
<ESMA_QUESTION_PHDG_1>

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

<ESMA_QUESTION_PHDG_2>
The FXPA believes that, in response to paragraph (7), one of the two trading practices considered should not be “a liquidity provider trading ahead of a pending order,” but rather “a liquidity provider trading ahead of a **potential** pending order.” [emphasis added]

<ESMA_QUESTION_PHDG_2>

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

<ESMA_QUESTION_PHDG_3>
The FXPA believes the Global FX Code appropriately distinguished pre-hedging and hedging by noting that “any trading activity after the acceptance of the firm quote by the liquidity consumer is deemed hedging.”
<ESMA_QUESTION_PHDG_3>

Q4 Do you have any specific concerns with respect to the practice of pre hedging being undertaken by liquidity providers when the trading protocol allows for a ‘last look’?

<ESMA_QUESTION_PHDG_4>
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Q5 What is your view on the arguments presented in favour and against pre-hedging?

<ESMA_QUESTION_PHDG_5>
The FXPA believes the balanced arguments presented on both sides of the pre-hedging debate are generally accurate.

However, specific to the FX market, the FXPA believes the Global FX Committee Commentary on Principle 11 should be considered in the context of these arguments. Specifically, in favour of hedging, the Global FX Committee observed that the “intent of any pre-hedging by the liquidity provider should always be to benefit the liquidity consumer and help facilitate the transaction.” On the other hand, the Commentary also noted that “pre-hedging may result in an adverse outcome for the liquidity consumer depending on the circumstances.”

The FXPA encourages ESMA to consider the Global FX Committee’s work on this issue, including the above-mentioned principles and commentary, when developing broader pre-hedging policies.

Finally, the FXPA believes that the example provided in Section 3.2, paragraph 25 does not provide enough certainty to serve as a working definition of pre-hedging.
<ESMA_QUESTION_PHDG_5>

Q6 In which cases could a foreseeable transaction enable a conclusion to be drawn on its effect on the prices?

<ESMA_QUESTION_PHDG_6>
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Q7 Do you agree that an RFM when the liquidity provider could discover the trading intentions of the sender on the basis of their past commercial relationship, the market conditions or the news flow should be considered as precise information?

<ESMA_QUESTION_PHDG_7>
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<ESMA_QUESTION_PHDG_7>

Q8 Please provide your views regarding the criteria for the identification of RFQs that could potentially have a significant impact on the price of the relevant financial instrument. Is there any other criterion that ESMA should take into account?

<ESMA_QUESTION_PHDG_8>
The FXPA would oppose the establishment of rules or regulations that include a list of factors that may have a significant impact on the price of a relevant financial instrument. While the FXPA recognizes that certain factors, such as RFQ size, direction, and instrument may have an impact on price, it would be difficult to establish a finite set of criteria without discretion or recognition that different markets and different products will be more (or less) impacted than others.
<ESMA_QUESTION_PHDG_8>

Q9 Does the GFXC Guidance describe all the possible cases of risk management rationale that could justify legitimate pre-hedging? If not, please elaborate

<ESMA_QUESTION_PHDG_9>
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Q10 Can you identify practical examples of pre-hedging practices with/without a risk management rationale?

<ESMA_QUESTION_PHDG_10>
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Q11 Can pre-hedging be considered legitimate when the market participant is aware, on the basis of objective circumstances, that it will not be awarded the transaction?

<ESMA_QUESTION_PHDG_11>

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Q12 Can you identify financial instruments that should/should not be used for pre-hedging purposes? Please elaborate

<ESMA_QUESTION_PHDG_12>
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<ESMA_QUESTION_PHDG_12>

Q13 Please provide your views on the proposed indicators of legitimate and illegitimate pre-hedging. Would you suggest any other?

<ESMA_QUESTION_PHDG_13>
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<ESMA_QUESTION_PHDG_13>

Q14 According to your experience, can express consent to pre-hedging be provided on a case-by-case basis in the context of electronic and competitive RFQs? If yes, how? Do you think the client's consent to pre-hedging should ground a presumption of legitimacy of the liquidity provider's behaviour?

<ESMA_QUESTION_PHDG_14>
For liquidity providers, it would be challenging to accept or receive express consent from clients on a case-by-case basis for all order types. For example, for RFQs, a liquidity provider's system cannot easily capture and integrate a client's preference or consent to pre-hedge.

The FXPA does not believe that a client's consent to pre-hedging constitutes an indication that the liquidity provider is always pre-hedging in the interest of the client. A client's consent, directing the liquidity provider to pre-hedge on a case-by-case basis, establishes a presumption of legitimacy of the liquidity provider's behaviour, but is not directly connected to the liquidity provider's behaviour.
<ESMA_QUESTION_PHDG_14>

Q15 Could you please indicate which are in your view the pre-hedging practices that appear to be conducted mostly in the interest of the liquidity provider and which may risk to not bring any benefit to the client?

<ESMA_QUESTION_PHDG_15>
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<ESMA_QUESTION_PHDG_15>

Q16 Do you think it would be feasible for liquidity providers to provide evidence of (i) their reasonable expectation to conclude the transaction; (i) the risk management needs behind the transactions; (iii) the benefit for the client pursued through the transaction and (iv) the client's consent? If no, please indicate potential obstacles to the provision of such evidence.

<ESMA_QUESTION_PHDG_16>
No, the FXPA does not believe it would be feasible for liquidity providers to provide this evidence.
<ESMA_QUESTION_PHDG_16>

Q17 Do you believe that the liquidity of a financial instrument should be considered as an indicator in determining whether pre-hedging may be illegitimate behaviour? Please elaborate.

<ESMA_QUESTION_PHDG_17>
No. The liquidity of a financial instrument should not be considered when determining whether pre-hedging may be illegitimate behaviour. However, if ESMA determines to consider the liquidity of a financial instrument, liquidity should be considered alongside the type of product and its size.
<ESMA_QUESTION_PHDG_17>

Q18 According to your experience does the practice of pre-hedging primarily take place in what is described as the 'wholesale markets' space or does this practice take place also with respect to order / RFQs submitted by retail or professional clients?

<ESMA_QUESTION_PHDG_18>
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Q19 As an investment firm conducting pre-hedging, do you have any internal procedure addressing the COI which might arise specifically from such practice? If yes, please briefly explain the content of such procedure.

<ESMA_QUESTION_PHDG_19>
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<ESMA_QUESTION_PHDG_19>

Q20 According to current market practice, do investment firms disclose to clients that their RFQs might be pre-hedged? If so, does this happen on a case-by-case basis (i.e. a client is informed that a specific order might be pre-hedged) or is this rather a general disclosure? Please elaborate, distinguishing between various trading models, e.g. voice trading vs electronic trades and please specify if there are instances in which RFQ systems allow to specify is pre-hedging is conducted?

<ESMA_QUESTION_PHDG_20>
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Q21 According to current market practice, are clients offered quotes with and without pre-hedging, leaving to the client a choice depending on his execution preferences? Is so in which instances?

<ESMA_QUESTION_PHDG_21>
In the FX market, clients have a choice regarding execution preferences. If a bank discloses its pre-hedging policy, notifying clients that they are continuously pre-hedging, the client has the choice of whether or not to transact with that liquidity provider. If the client prefers quotes without pre-hedging, it can utilize another bank or use an algorithm.
<ESMA_QUESTION_PHDG_21>

Q22 Do you currently keep record of pre-hedging trades and related trading activity? Do you believe record keeping in this instance would be easy to implement?

<ESMA_QUESTION_PHDG_22>
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Q23 Would you like to highlight any specific issue related to the obligation to provide clear and not misleading information?

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Q24 Should ESMA consider any other element with respect to pre-hedging and systematic internalisers and OTFs? Please elaborate

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