Svensk Värdepappersmarknad
Swedish Securities Markets Association

The Swedish Securities Markets Association's general comments to ESMA's Call for Evidence on Pre-hedging

The Swedish Securities Markets Association (the SSMA or the Association) appreciates the opportunity to express its views and feed its insights into ESMA's ongoing work on developing appropriate guidance as regards pre-hedging. The SSMA strongly supports this work and ESMA's intention to create some clarity in this grey-zone, and the Association firmly believes that more clarity will benefit all market participants. Before the SSMA provides its responses to the concrete questions in the consultation paper, it would like to share some general comments regarding pre-hedging.

It is the SSMA's opinion that pre-hedging is a vital element in order to ensure liquidity in the financial markets, as well as an important tool for banks or investment firms to effectively manage their risk when acting as a counterparty in their function as market makers providing liquidity to the market.

Pre-hedging is to the benefit of customers by enabling investment service providers to offer competitive pricing, and it may in certain cases be necessary in order for certain transactions to even be possible to execute. Any legislation and/or guidelines in this field should be carefully considered and pre-hedging should not be deemed as misuse of client information, provided that the pre-hedging is performed in pursuit of the legitimate activities in the provision of investment services or as market maker or liquidity provider. The SSMA would like to emphasize that if pre-hedging of orders and transactions would be further limited, there is an apparent risk that the market for certain financial instruments will disappear to the detriment of the investors and the market.

The SSMA supports transparency in trading practices by disclosing to the customer, where appropriate, that pre-hedging might be necessary before an exact price can be offered. This would enable investors to make an informed decision when asking for prices and increase agreement with customers whether the investment service provider or market maker may engage in pre-hedging activities (i.e., the investor may be willing to accept a higher bid/offer spread). Such disclosure might, however, on a trade-by-trade basis entail that the customer will have inside information, and any disclosure of pre-hedging requires assessment on a trade-by-trade basis. As a comparative example, general disclosure of pre-hedging practices is allowed under the FX Global Code.

The SSMA believes that pre-hedging is conducted in the interest of and for the benefit of the customer to enable the investment firm to provide a price or quote and ensure successful execution and completion of a transaction. In some cases, pre-hedging is even necessary in order to ensure that a transaction is possible to execute, for example if there is low liquidity in a market or a relevant financial instrument (for example illiquid currencies, rates or other financial instruments). Pre-hedging is not conducted for the benefit of the investment firms or banks or for them to make a profit. If pre-hedging is performed other than for the benefit of the customer, it might be considered misuse of client information, or it might constitute proprietary trading which is already subject to regulation.

Amongst other factors, market makers form their pricing on information about the likely pattern and depth of future demand and supply. Where a market is lacking instantaneous depth, an OTC transaction may significantly impact the price on a financial instrument and move market prices against the end-user if executed in a single transaction. Market makers and investment firms specialise in gathering information about demand and supply and providing temporary balance sheet capacity making

continuous two-way prices available to investors in return for compensation via a bid/offer spread. This allows end-users to transact smoothly in and out of large positions without excessive price volatility, even where the underlying instruments may be relatively illiquid or less standardised.

When responding to an RFQ, the market maker or the liquidity provider may risk experiencing price movements after having provided the customer with a firm quote eligible for trading. This risk is reflected in the RFQ provided to the customer, but for large-sized transactions or less standardised assets or in markets lacking instantaneous depth, a narrower spread can be provided to the customer if the market maker or liquidity provider is able to pre-hedge the risk of taking the trade to its own book, provided that the benefit hereof is passed on to the customer through the narrower spread. Where the market maker or liquidity provider is unable to pre-hedge this risk in response to the anticipated order, market makers may have to widen the spreads to price in this risk, reducing market efficiency for the end-user.

It could also be questionable whether it is appropriate to conduct a transaction where it may not be possible to hedge the risk, since the bank might not be able to offset the risk, which in turn will affect the price that the customer has to pay. It is important to note that pre-hedging is a by-product of other transactions which might not be possible to conduct unless it is possible to pre-hedge this risk, e.g., bond issuances and M&A transactions. If a bank would assume risk in a customer transaction that it will not be able to hedge, it would increase risks in the trading book and increase the cost of funds. This may discourage banks or investment firms from conducting transactions, thus impacting the liquidity and the risks in the whole financial system.

Where the market maker or liquidity provider is asked in competition with others, pre-hedging may exercise price pressure in the interdealer market impacting other firms' ability to provide competitive quotes or impacting the compensation via their bid/offer spread if they have already provided a firm quote to the customer. This is more frequent in markets lacking instantaneous depth. Hedging needs are dependent on the current positions and the trading flow of the market maker or liquidity provider.

Additionally, as regards competitive RFQs, the market maker or liquidity provider should at least be able to pre-hedge a possible transaction in line with its estimation of its chances of being awarded the transaction.

The need to take principal risk gives market makers an interest in future price movements that can benefit, but may also sometimes conflict with, the interest of their clients as they often must trade simultaneously as a principal with clients, e.g., when responding to a quote, and for themselves, e.g., when trading in markets to implement hedges and manage inventory.

MiFID II/MiFIR conduct rules include the obligation for investment firms to act honestly, fairly and professionally in a manner which promotes the integrity of the market (Article 24 of MiFIR) and to act in accordance with the best interest of clients. (Article 24 of MiFID II). These requirements address the risk of inappropriate behaviour in the interdealer market and in customer facing activities. Trading venues also conduct market surveillance and monitoring to detect any inappropriate behaviour that may jeopardise the fair and efficient operation of the market. Investment firms are also required to include pre-hedging activities in their own monitoring and surveillance according to Article 16 of MAR.

It is important to remember that there are differences as to how financial markets function and what drives and forms the price across different asset classes, e.g., FX, equities, interest rates, structured

products, commodities, etc. And even within each of these asset classes there are huge differences in the depth of the liquidity pool, for example a EUR benchmark government bond vs. a DKK mortgage bond in a closed bond series. To a large extent the SSMA's responses to the questions in the consultation paper are provided with an outset in the FX market and may or may not be unique to this market. Differences between financial products and markets need to be reflected and taken into consideration if ESMA proceeds with developing appropriate guidance as regards pre-hedging.

Finally, the SSMA's responses take outset in the case (i) scenario, defined in chapter 2, paragraphs 7 and 8, in the Call for Evidence. Many of the Association's responses would have been different if they had taken outset in the case (ii) scenario, defined in the Call for Evidence's chapter 2, paragraphs 7 and 9. The SSMA, therefore, strongly encourages ESMA to publish and run a separate consultation, if ESMA in the future intends to explore whether any guidance should be expanded to also cover case (ii) scenarios.