FMSB

Summary

Pre-hedging: case studies

What is pre-hedging?

The practice is generally understood as hedging where 'liquidity providers aim to hedge inventory risk in an anticipatory manner,' as defined by ESMA in its 2023 Call for Evidence on the practice. More specifically, ESMA refers to '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'. FMSB adopted ESMA's definition for the purposes of its work.

Why is FMSB examining the practice?

A founding objective of FMSB was to 'address areas of uncertainty in specific trading practices' through the development of guidelines and practical case studies. In principal markets, there remains uncertainty as to how and when pre-hedging may be undertaken, the rationale and client benefits deriving from the activity as well as the distinction between inventory management, pre-hedging and front running. The Spotlight Review considers trading practices, across the size and liquidity spectrum, in fixed income, FX and exchange traded funds (ETFs). It also considers evolving risk management practices around new issuances.

What is FMSB recommending?

The Spotlight Review supplements existing FMSB guidance applicable to pre-hedging deriving from the FMSB's Large Trades Standard – and considers its application beyond a large trades context - with a series of considerations, derived from case studies, debated by FMSB's Pre-Hedging Working Group. The table below summarises the guidance set out in the Large Trades Standard and the supplementary considerations from the Spotlight Review.

	Existing FMSB guidance (Large Trades)	Considerations
Pre-trade	'Pre-hedging should only be undertaken where the client has been made aware in advance that pre-hedging may take place and could have an impact on the market price of the instrument. The liquidity provider should consider, taking into account factors such as the expertise of the client, the nature of the client relationship and frequency with which the client enters into comparable transactions, whether it is necessary to make such disclosure on a trade-by-trade or other basis.'	• Liquidity providers to take reasonable steps to promote client understanding of their pre-hedging practices. The frequency of disclosures to achieve this, and whether they are made on a periodic or trade-by-trade basis may be informed by factors including the method of execution, the nature and size of the transaction, the expertise of the client, the nature of the client relationship and frequency with which the client enters into comparable transactions. • Liquidity providers to, where applicable, disclose that pre-hedging may negatively impact the liquidity or price that the client receives and highlight that such negative market impact or client outcome may be greater in illiquid products or during periods of low market liquidity. • For transactions executed through electronic platforms, transaction-specific communications will typically not be practicable. LPs instead implement periodic, ex ante disclosures. • For Large Trades the timing and frequency of disclosure should follow the guidance set out in the Standard.
Execution	'Pre-hedging should only occur where the liquidity provider expects to take on market risk and is undertaken at the liquidity provider's own risk.'	• A liquidity provider should not use the information value inherent in a client request to inform its own trading activity ahead of the client trade without a legitimate expectation of winning such trade.
	'Pre-hedging should be reasonable relative to the size and nature of the	• For competitive RFQs, any pre-hedging should be reasonable relative to the size of the RFQ taking into account

	Existing FMSB guidance (Large Trades)	Considerations
	anticipated transaction taking into account the prevailing market conditions.'	the number of liquidity providers in competition where this is visible to the LP.
	'Pre-hedging should aim to minimise the impact of the activity on the market and be designed to facilitate the transaction.'	• Liquidity providers should not pre-hedge in a manner that they intend to, or is reasonably likely to, disrupt the market. • The market impact of pre-hedging in illiquid instruments is likely to be more material and needs to be carefully managed.
	'Pre-hedging should be designed to benefit the client and executed in a manner that is not meant to disadvantage the client.'	• Liquidity providers should consider the client's overall execution outcome when pre-hedging. This means considering both if pre-hedging enables the dealer to charge reduced spreads as well as any potential adverse impact pre-hedging activity may have on the execution price. • An example of where pre-hedging is beneficial to clients is where it enables the liquidity provider to charge reduced spreads that more than off-set any adverse impact the pre-hedging activity has on the execution price (other potential benefits of pre-hedging – including facilitating a client transaction - are set out in Section I, paragraph 4.4 above). • Any market activity of a liquidity provider using the information value of a live RFQ should be designed to benefit the client. This is the case irrespective of whether it is a one-way or two-way request. • Pre-hedging in index-based products (such as ETFs) should not be undertaken if improvements to client pricing or other benefits of pre-hedging are not likely to be present. This is because, in the context of index products: (i) the exact instruments underlying the index may be unknown and the time to transact in them will be longer than the RFQ is live; (ii) there is typically sufficient liquidity, where necessary, to hedge the risk in underlying instruments or correlated indices post-execution rather than in anticipation of the transaction; (iii) RFQs are typically shared with a larger number of liquidity providers meaning that the potential cumulative impact of any pre-hedging is greater.
Post-trade	N/A	• Liquidity providers should ensure that oversight of pre-hedging activities is incorporated into appropriate supervisory frameworks and is consistent with applicable industry codes and standards. To the extent that any adverse client outcome trends are identified, these should be addressed, and the output of such oversight should be used to inform future pre-hedging activity. • In the case of a large trade[1], if reasonably requested by a client, and subject to appropriate confidentiality and information handling restrictions, liquidity providers should provide the client with information on the pre-hedging activity undertaken and, where possible, the general observed impact of such pre-hedging activity on the client execution.

Next steps:

This Spotlight Review is intended to advance the industry debate on pre-hedging but not codify standards of behaviour. In due course, FMSB will determine if standard-setting would be beneficial in this area taking into account international regulatory developments with regard to pre-hedging.

[1] As defined in FMSB's Large Trades Standard