

The background of the slide features a dark purple grid pattern that resembles a low-angle view of skyscrapers. Overlaid on this are several large, semi-transparent circles in white, purple, and orange. The main title is centered in the upper half of the slide.

Pre-hedging in focus: How European asset managers view dealer practices and market impact

Commissioned by:





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Introduction



Pre-hedging is a divisive but relatively poorly understood topic. Defined as the act of executing a hedge in anticipation of a client trade that is yet to be awarded, pre-hedging's advocates claim that it improves market efficiency by allowing dealers to offer tighter spreads as they can better manage risk.

However, for detractors, pre-hedging can move prices against the client trade, create conflict of interest and distort competition among dealers.

Susquehanna agrees with the latter view and believes that pre-hedging is unacceptable and should be banned as dealers using such information can have a detrimental impact on the price received by the end-investor.

Currently there is little in the way of common standards for pre-hedging across asset classes.

Some market participants believe regional rules covering the practice are embedded in legislation focused on market abuse with the conclusion that pre-hedging is prohibited in most circumstances. Others believe that, as the legislation is not explicit, there are no clear rules on pre-hedging.

This looks set to change, however, as global regulatory bodies eye the development of common standards.

In order to better understand attitudes to pre-hedging among European asset managers, Susquehanna commissioned Acuiti to conduct an independent survey of leading asset managers within Europe.

This whitepaper analyses the findings of that study.

The key findings are:

- 92% of respondents said that pre-hedging has the potential to move the price away from their trade and provide a disadvantageous price
- Over 80% of respondents believe dealers should only hedge their positions after the trade has been awarded
- Only 7% of respondents said that pre-hedging should remain largely unrestricted
- Just 4% of respondents said they always know when a dealer is pre-hedging their trades
- Almost half of respondents have observed suspected pre-hedging activity, often leading to increased volatility and worse pricing
- Nearly 80% of asset managers surveyed supported more stringent regulation, either through clearer disclosure rules (41%) or outright restrictions in certain cases (37%)
- 59% believe dealers should always disclose pre-hedging on a trade-by-trade basis, and 50% want dealers to obtain prior client consent

Background to pre-hedging

The act of pre-hedging is when a dealer or liquidity provider upon receipt of information about a potential counterparty order trades in the same direction as that order before the trade has been awarded to the dealer.

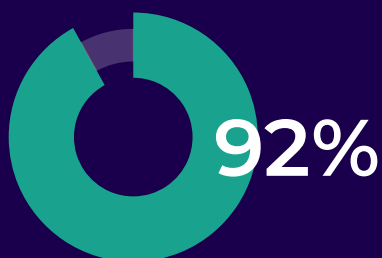
While pre-hedging is argued by some to be a vital tool in dealers' ability to manage the market risk that is anticipated to emanate from an expected client trade, its practice raises questions about market fairness, transparency and potential conflicts of interest.

Pre-hedging is a common and widely used

practice. However, its prevalence varies depending on the asset class, market conditions and the size and nature of the transaction.

It is most common for dealers to pre-hedge larger transactions or trades in markets with lower liquidity, where the risk of adverse market moves is higher.

It is also a widely used practice in electronic markets, in particular when dealers are bidding in Request-for-Quote (RFQ) venues or in the "call around" markets.



Of respondents said that pre-hedging has the potential to move the price away from their trade and provide a disadvantageous price



Regulatory frameworks

Owing to concerns over potential conflicts of interest between dealers and their clients or counterparties, regulators in the EU, UK and US have increased scrutiny of the practice of pre-hedging. However, currently, there are no consistent international standards governing pre-hedging.

In the US, there are specific requirements governing pre-hedging in block trades. For example, FINRA rule 5270 does not permit transactions to be undertaken to facilitate the execution of a shopped order until the trade has been awarded, effectively a ban on pre-hedging. The CME meanwhile requires that firms must have a belief that their trade will be executed as well as other requirements including that the dealer must be acting as a principal to the trade – effectively a ban on agency brokers pre-hedging.

In addition to these rules, the FX Global Code sets out similar requirements as well as imposing disclosure requirements on pre-hedging. National regulators have typically not directly regulated pre-hedging, instead embedding requirements within existing

frameworks such as market abuse or best execution, where market participants have to infer what is and what is not permitted.

The EU's European Securities and Markets Authority (ESMA) conducted a review of the process in 2023. It concluded that pre-hedging carries a risk of conflicts of interest and abusive behaviour – but not sufficient to justify a complete ban. ESMA said that it would consider future guidance but emphasised the market abuse requirements set out in MiFID II as a reference point for any consideration of pre-hedging. Similarly, in the UK, there are no rules specific to pre-hedging across all asset classes. Instead, guidance is shaped by the Market Abuse Regime and the FX Global Code.

In response to the relative lack of a comprehensive regulatory framework, regulatory bodies are seeking to develop global standards. The International Organization of Securities Commissions (IOSCO), which includes UK, EU and US regulators, is in the process of developing global standards. In addition, last year, the FICC Markets Standard Board published a paper on pre-hedging.

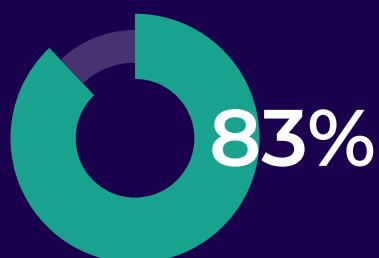
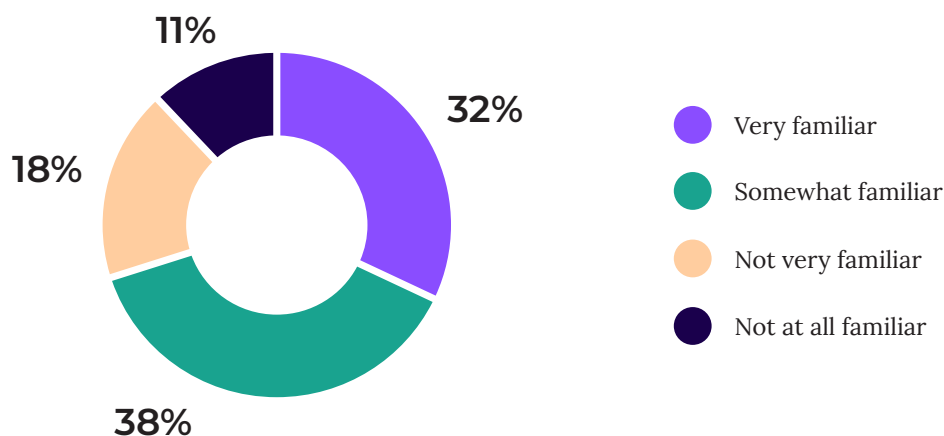


Attitudes to pre-hedging

The findings of the survey of senior trading-focused executives at European asset managers found relatively high levels of awareness of the concept of pre-hedging.

Eight-nine percent of respondents had at least some awareness of pre-hedging. A third were very familiar, while just over one in 10 were not familiar with the concept.

How familiar are you with the concept of pre-hedging?



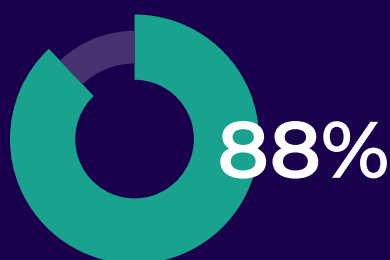
Of respondents said a dealer should only hedge after a trade has been awarded

However, awareness has not led to acceptance. In general asset managers are understanding of dealers' need to manage risk, but no respondents said that pre-hedging was always a legitimate risk management practice and 41% said that it is not acceptable as it creates unfair advantages.

Of those that thought pre-hedging was acceptable in certain instances (47%), most said this was when there is a genuine risk management objective. Smaller numbers said that it was ok in instances in which the dealer is executing a larger trade, or trading in volatile markets. However, over 80% of respondents said that hedging should only occur after a trade has been awarded.

The question of whether pre-hedging is more, or less, acceptable in a competitive scenario, such as an RFQ bid is a complex topic. Firstly, there is the question of whether a dealer can have a realistic expectation that they will be filled on their quote.

There are also significant concerns around the increased market impact if multiple dealers pre-hedge the same RFQs and about dealers exiting positions quickly (to their benefit) where they pre-hedge but then do not subsequently win the trade. As a result, only 13% of the subset of respondents who thought pre-hedging was acceptable in certain scenarios, said pre-hedging is acceptable in a competitive bidding scenario.



Of respondents said that pre-hedging creates a conflict of interest between the dealer and the client

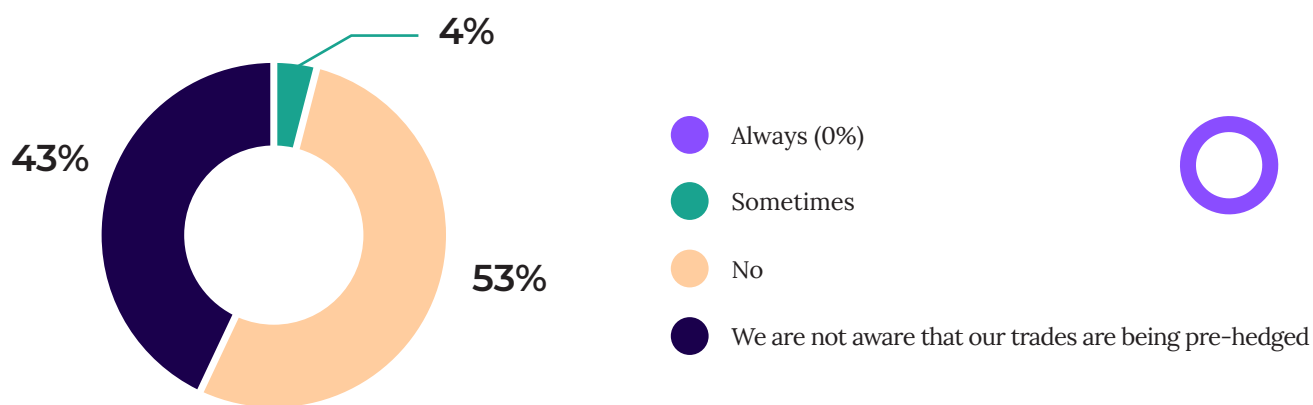


Disclosure and market impact

A significant finding of this survey is the relative lack of transparency surrounding pre-hedging. Just 4% of respondents said that

dealers disclosed directly to them that they were pre-hedging a trade.

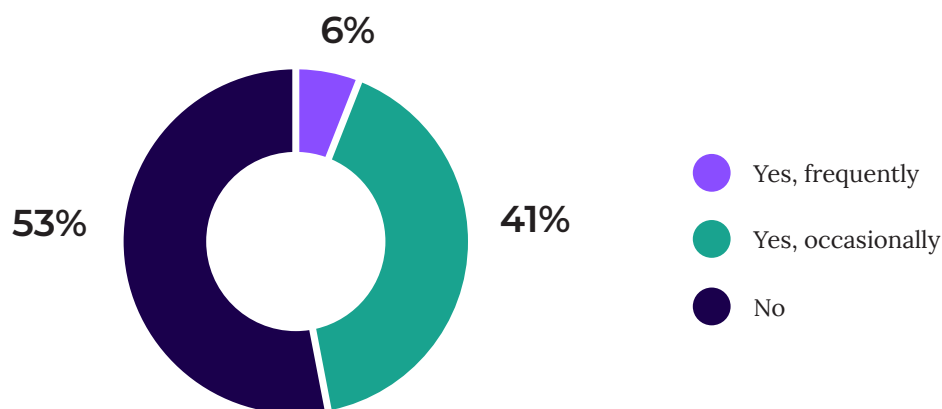
Do dealers disclose directly to you when they are going to pre-hedge a trade?

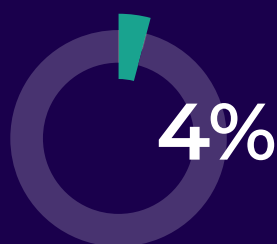


Almost half of respondents, however, said that they had observed what they believed to be pre-hedging activity by dealers. Of those,

75% said that this had resulted in increased volatility around the trade and around half that they had experienced worse pricing.

Have you ever observed pre-hedging activity by dealers when executing trades?



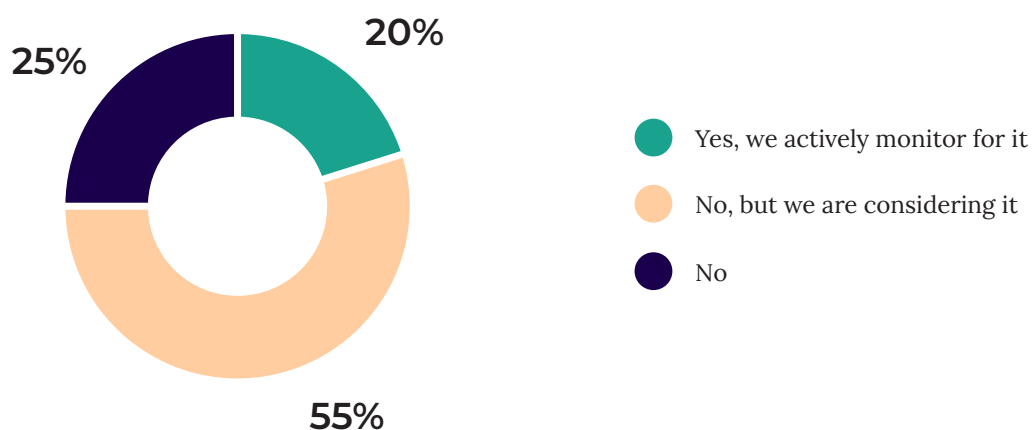


Of respondents to the survey said that they were confident that they always knew when their trade was being pre-hedged by a dealer

The buy-side is taking action. While a quarter of respondents did not have mechanisms in place to detect pre-hedging, over half were

considering implementing such processes and a fifth already had them in place.

Do you have mechanisms in place to detect or mitigate potential pre-hedging by dealers?

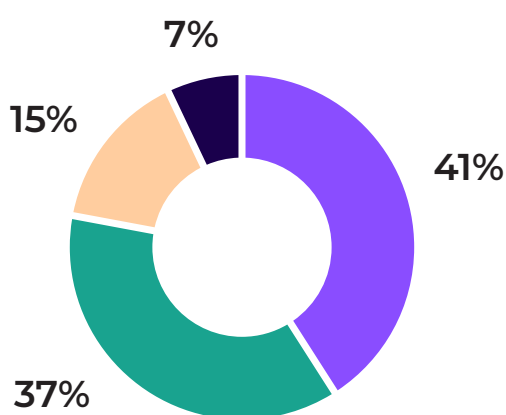


Policy response

This survey found that asset managers are, on the whole, sympathetic to the needs of dealers to manage risk when executing trades. However, 78% of respondents are calling for

more strict regulation of pre-hedging. They want much more transparency over pre-hedging and a coherent set of standards for the practice.

Should pre-hedging by dealers be more strictly regulated?

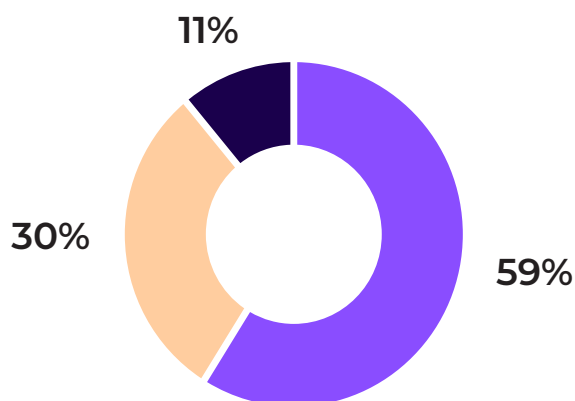


- Yes, with clear disclosure requirements
- Yes, with outright restrictions in certain cases
- No, current regulations are sufficient
- No, pre-hedging should remain largely unrestricted

Thirty-seven percent of respondents called for outright restrictions of pre-hedging and less than a quarter thought that the current regulatory framework was sufficient. When it came to disclosure, 41% are calling for clear

disclosure requirements, with just 11% thinking that disclosure would hinder market efficiency and 59% saying that dealers should always be required to disclose pre-hedging.

Do you believe dealers should be required to provide upfront disclosure of pre-hedging activity on a trade-by-trade basis?

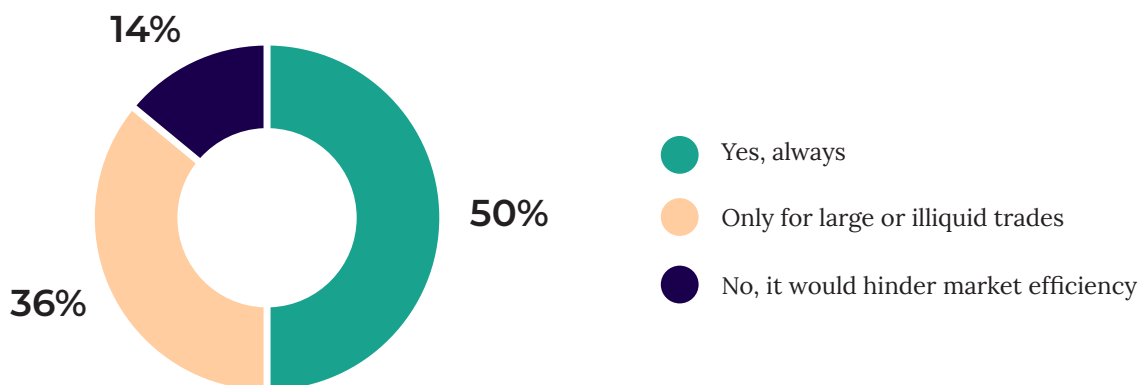


- Yes, always
- Only for large or illiquid trades
- No, it would hinder market efficiency

There was also a strong sentiment to receive consent, with half of respondents saying it

should be required and just 14% that it would hinder market efficiency.

Do you believe dealers should be required to receive consent from a client prior to engaging in pre-hedging?



Conclusion

The purpose of this study was to analyse the views of asset managers in Europe on pre-hedging by dealers and liquidity providers. Pre-hedging has long been a misunderstood and

often under-considered process in the market. However, this study finds that the buy-side in Europe is calling for greater restrictions and clearer guidelines around its usage.

Do you agree or disagree with the following statements:

Pre-hedging has the potential to move the price away from my trade and provide me with a disadvantageous price

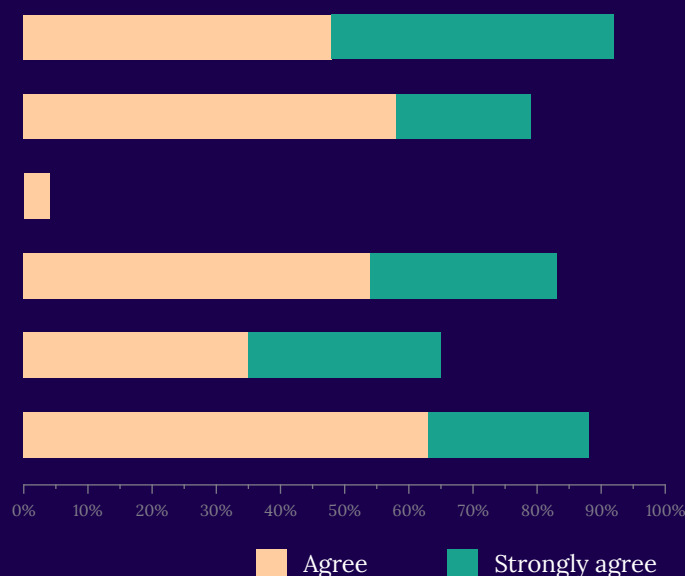
Including a dealer that pre-hedges in a competitive RFQ is likely to result in a worse price for my trade

We are confident that we always know when a dealer is pre-hedging our trades

Dealers should only hedge trades after they have been awarded the trade

I should have to give my consent for a dealer to pre-hedge a trade I am submitting

Pre-hedging creates a conflict of interest between the dealer and the client



Respondents to this survey were in near universal agreement that pre-hedging has the potential to disadvantage their trade and created a conflict of interest between the dealer and the client. At the same time, just 4% are confident that they know when a dealer is pre-hedging.

The European buy-side understands dealers' needs to manage risk. However, over 80% believe dealers should only hedge trades after they have been awarded the trade. To avoid detrimental market impacts, 78% said they want stricter regulations and a more comprehensive framework around its usage.

In the interim, the buy-side today has the opportunity to set house rules regarding pre-hedging and mandate disclosure in its agreements with counterparties. In addition, this study found that firms are taking more of a proactive approach in monitoring for pre-hedging of their trades.

This is a trend that is likely to continue. Asset managers are of the view that pre-hedging has significant risks, but could have potential legitimate uses under certain conditions. They are calling on regulators to set clear rules governing pre-hedging.



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