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SPECIAL FORCES

Market making is not a new form of trading, but paradigm changes in regulation, market structure and technology have also changed the approaches of market makers over the past decade or so. Aiming at preserving capital and balance sheet capacity, an ever-increasing focus is on hedging strategies. We asked **Thibault Gobert, Head of Liquidity Pool at Spectrum Markets**, what pre-hedging is and why this is a critical topic now.

Thibault, Spectrum Markets got off to an impressive start in an environment that couldn't have been much more difficult. Which role have market makers been playing in that context and how has the environment changed for them?

It's almost a truism that the role of market makers is crucial for market efficiency and its overall functioning. However, the past three years held particular challenges, driven by external shocks that led to extraordinary market conditions. Providing liquidity, i.e., keeping trading upright and maintaining price continuity is comparable to supplying households with energy or heating – market takers consider it a given and only start worrying about it once it becomes or is about to become interrupted. As an investor, you expect that there is someone in the market who is willing to take the other side of your trade at every point in time. However, even for the most actively traded securities there are points when the price, size or time of an order doesn't match with that of a natural trading counterparty. In offering continuous two-side quotations with tight bid-ask spreads, the market maker bridges the gaps between buyers and sellers and thus keeps the market efficient. As an investor, or market taker, you expect this to work even during volatile market periods.

While in the recent past circumstances were certainly exceptional, undergoing cyclical fluctuations is inherent to the business. However, there are structural changes, too, mainly driven by regulation and technology, which have been quite impactful over recent years. In order to better understand how this is relevant here, we may look at the components that determine the profit and loss (P&L) of a market maker, both on the services performance and the inventory side. From its quotation activities, the market maker will try to generate a profit from the bid-ask spread after trading costs. The inventory P&L is driven by the changes in market value of a given position, its carry, funding costs, the hedging result and capital costs, and of course the result from securities lending and borrowing activities.

The Basel III[1] framework had a significant impact in terms of capital costs due to higher own funds requirements and in terms of funding costs through stricter liquidity requirements. OTC derivatives reforms brought about by MiFID II/MiFIR[2] or EMIR[3] led to a number of requirements such as central clearing, stricter margining and much higher transparency. While these can all be considered important from a market stability and investor protection perspective, they have significantly increased capital, clearing, hedging and compliance costs for market makers. Obviously, where a multi-asset market maker will want to continue to provide liquidity even in non-core, less liquid securities, the firm must strive to optimise every business component to remain bottom-line profitable. This will become even more important where additional challenges occur such as facilitating real-time trading across time zones or throughout phases of extreme volatility. In this context, it must be noted that regulation continues to be a very sensitive factor, as the pre-hedging discussion shows.

Could you please explain what this discussion is about?

Generally, pre-hedging is the trading strategy of hedging a position before actually entering into the trade, as opposed to entering into the hedge after taking the position. This is where the common industry understanding of the practice ends. But there's more to it. For liquidity providers, it is a useful strategy to manage their inventory risk which, as discussed, has a significant impact on their profitability. ESMA[4] started a call for evidence (CFE)[5] in July of last year regarding the practice of pre-hedging. While pre-hedging is not defined in European Union law, ESMA, after receiving requests from national competent authorities, has started looking into whether it may constitute a breach of the market abuse regulation (MAR)[6] or business conduct rules under MiFID II. In other words, whether it constitutes front-running, which is a form of insider trading or a conflict of interest.

Is either of the suspected misbehaviours applicable here?

This is more complex than it appears at first glance. Of course, where there is a bilateral trade between two counterparties, the picture seems to be quite clear. That is, if you're a market maker and you negotiate a transaction that will be executed at some point in the future, it is legitimate to pre-hedge the position you know you will be taking as long as you give prior notice to your client of this general practice of yours and you have obtained the client's consent to it. Otherwise, conflicts of interest may arise. Now there are strongly diverging views in the industry of what constitutes pre-hedging in the first place, where it should be considered a lawful practice and where it shouldn't. Clearly, it must be made clear what pre-hedging is in order to categorise any particular practice and, if it is deemed to meet the definition of pre-hedging, to assess whether it has been applied legitimately or not.

ESMA explains that it considers pre-hedging to be where inventory risk mitigation takes place ahead of the execution of a trade – as opposed to traditional hedging, where risk mitigation takes place after the trade execution. Some industry participants argue that the trade execution timestamp is not the correct determination metric for whether hedging or pre-hedging is concerned. Following this reasoning, the distinction should be made between whether or not the risk from the trade is known at the point in time of taking a hedge position.

What do you think should be the relevant criteria?

I think such a definition will be difficult to design. You may know the position that will need to be hedged prior to a trade but the conditions will be known only at execution. Since there is significant leeway for the conditions to change in the meantime, there will be situations where it is inappropriate to state that the risk is known from a mathematical standpoint. This definition sensitivity becomes clearer within another scenario which is at least as critical in practice, and which has been the cause for contemplating the legal context of pre-hedging – remember that there hasn't even been a legal definition of the term. This scenario is relevant in association with request for execution (RFE)[7] platforms. Increasingly so in light of the significant rise of exchange traded funds (ETFs).

RFE platforms were originally established to enhance electronic trading in fixed income markets. Over time, their flexibility in terms of integration into existing trading infrastructures and the high degree of trade automation has made them a go-to solution for large buy-side accounts such as ETFs – allowing them to combine customised, straightforward execution with MiFID II compliant levels of transparency and best execution requirements. Now, if an ETF is requesting a quote via an RFE platform, either all connected dealers or only those pre-selected by the investor will receive this RFE, depending on the type of platform. Either way, dealers receiving the RFE are in competition for the block of securities to be bought or sold by the ETF. This has led to the practice that some dealers, in a bet on getting the trade, build a hedge position before the investor that published the RFE has decided on who to trade with. This can have a number of adverse effects, the most impactful for the investor being that the anticipated hedge transaction affects market prices, thus causing losses for the trade the execution intention of which was published via the RFE platform. Note by the way that at Spectrum Markets, we offer market makers both the firm (hit and take) or indicative (RFE) liquidity provision models.

Claiming that every pre-hedging activity automatically qualifies as front-running given the non-public character of RFEs is too far-reaching a conclusion, in my view. However, in the case of highly liquid securities where there is no reasonable risk management rationale, one may argue that every RFE-related transaction by a dealer who has not (or not yet) been chosen to trade with bears insider trading risks.

On the other hand, should the market move counter to the investor's expectations as a result of pre-hedging activities or other developments, the investor is free to not execute the trade. In addition, it is common practice among institutional accounts to send two-sided RFEs for large and very large trades, camouflaging the intended direction of the trade. Then again, the largest liquidity providers mostly have a good view on institutional portfolios anyway. So whichever way you look at it, there are multiple dimensions to consider which is why there is neither a simple definition of when a practice can be considered pre-hedging, nor would an outright prohibition of every pre-hedging activity be a good solution. It remains to be seen if and how ESMA will act upon the responses received from market participants to the CFE it sent. The uncertainty inherent in this matter is anyhow creating a further impediment for liquidity providers.

Thank you very much!

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[1] Directive 2013/36/EU (CRD IV) and Regulation 575/2013 (CRR), together referred to as Basel III
[2] Directive 2014/65/EU, the Market in Financial Instruments Directive
[3] Regulation (EU) No 648/2012, the European Market Infrastructure
[4] The European Securities and Markets Authority
[5] Public consultation of European authorities inviting all interested parties to provide feedback and empirical evidence on the benefits, unintended effects, consistency and coherence of a financial legislation
[6] Regulation (EU) No 596/2014, the Market Abuse Regulation
[7] Also known as RFQ (Request for quote) platforms

Please don't hesitate to get in touch if you wish to receive further detail. spectrum-markets.com

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