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| Response Form to the Call for evidence on pre-hedging |
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**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](http://www.esma.europa.eu) under the heading [Legal Notice](http://www.esma.europa.eu/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.

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**General information about respondent**

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| Name of the company / organisation | German Banking Industry Committee |
| Activity | Banking sector |
| Are you representing an association? |  |
| Country/Region | Germany |

**Questions**

1. 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 German Banking Industry Committee is the joint committee operated by the central associations of the German banking industry. These associations are the Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR), for the cooperative banks, the Bundesverband deutscher Banken (BdB), for the private commercial banks, the Bundesverband Öffentlicher Banken Deutschlands (VÖB), for the public banks, the Deutscher Sparkassen- und Giroverband (DSGV), for the savings banks finance group, and the Verband deutscher Pfandbriefbanken (vdp), for the Pfandbrief banks. Collectively, they represent approximately 1,700 banks.

We generally support ESMA’s intension to provide better clarity for the European market with regard to pre-hedging activities. We would like to point out that we strongly support the definitions and guidance relating to pre-hedging set out in the Global FX Code (GFXC) and the FICC Markets Standards Board (FMSB) Guidance on large trades which provide sufficient guidance on this topic in what are essentially global markets. ESMA’s proposed definition of pre-hedging seems workable but needs some clarification. Our understanding of ‘potential’ in no. 5 (of “2 Working definition of pre-hedging”) is that the risk of having to be hedged is unknown. The unknown risk is an essential component of pre-hedging which differentiates it from hedging. Therefore, we would suggest a clarification in this regard.

<ESMA\_QUESTION\_PHDG\_1>

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

<ESMA\_QUESTION\_PHDG\_2>

No, we do not believe that the definition should encompass other market practices – case (i) and (ii) seem sufficient.

<ESMA\_QUESTION\_PHDG\_2>

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

<ESMA\_QUESTION\_PHDG\_3>

We agree in principle but refer also to our answer to Q1.

<ESMA\_QUESTION\_PHDG\_3>

1. 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>

No key concerns as existing guidance such as the GFXC is sufficient in mitigating potential abusive practices relating to ‘last look’.

<ESMA\_QUESTION\_PHDG\_4>

1. What is your view on the arguments presented in favour and against pre-hedging?

<ESMA\_QUESTION\_PHDG\_5>

We agree with the advantages of pre-hedging set out in the CfE, particularly that pre-hedging enables liquidity providers to provide quotes in less liquid markets. Counterparties who are concerned about pre-hedging can ask for a two-way quote so that the direction is not known. If firms do pre-hedge, then any price improvement from the inventory acquired at a known price should be passed onto the client and it seems likely in a competitive environment that if that is not done, the liquidity provider would be removed eventually from the panel of firms asked to quote.

We disagree with the argument given about “there not been a risk management rationale existing for pre-hedging in a liquid market”. In liquid markets spreads are very tight and there is insufficient liquidity at the top of the book to satisfy large client orders without risk being taken by the market maker. Not allowing any pre-hedging might result in wider prices or spreads, resulting in firms refusing to quote in illiquid financial instruments. Pre-hedging allows for the continuous sourcing of liquidity and mitigates the impact markets faced by potential volatility spikes triggered by significant transactions being brought to the market.

<ESMA\_QUESTION\_PHDG\_5>

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

<ESMA\_QUESTION\_PHDG\_6>

The Market Abuse Regulation has already set out the definition of what amounts to inside information and what is ‘foreseeable’, therefore we do not see a need for additional guidance on whether an RFQ can amount to inside information. Furthermore, RFQs should not be typically considered as inside information and any assessment of such should be made on a case-by-case basis.

<ESMA\_QUESTION\_PHDG\_6>

1. 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>

No, we do not agree. Precise information implies certainty, and this is not always the case, as in the context of a RFQ or RFM, the liquidity provider could be exploring where the market is. Another example is that liquidity takers will split orders up into different lots, therefore it is very hard to conclude what is happening once a RFQ is received.

A RFQ is regularly sent out to multiple parties. From the perspective of the liquidity provider, it is not transparent to how many and which liquidity provider it is not transparent to how many liquidity provider prices were sent. In other words, there is no transparency on the past and current competition. Therefore, it is unclear whether the current situation differs from the past and whether past winning/losing the quote probabilities are reasonable for the future.

<ESMA\_QUESTION\_PHDG\_7>

1. 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>

It is not clear what “significant impact” means in this context. From a market maker perspective, a “significant impact” is any movement in the market away from the market makers price before it is hedged. That would in general not be a “significant impact” for other people in most markets. In terms of market liquidity, small RFQs are more likely to have an “significant impact” in illiquid markets than in liquid markets.

There are many factors, including but not limited to, the type of instrument, liquidity profile, and size of transaction that would have an impact on the price of a financial instrument. The relative importance of these factors would vary on a case-by-case and day-to-day basis. Therefore, the creation of an exhaustive list of criteria by ESMA would not capture the dynamic nature of the financial instruments and markets in which they are traded.

<ESMA\_QUESTION\_PHDG\_8>

1. 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>

Yes, from our perspective the GFXC presents helpful and practically relevant cases of risk management rationale for which legitimate pre-hedging is justified.

<ESMA\_QUESTION\_PHDG\_9>

1. Can you identify practical examples of pre-hedging practices with/without a risk management rationale?

<ESMA\_QUESTION\_PHDG\_10>

Pre-hedging practices are not carried out without a risk management rationale, in line with the GFXC on pre-hedging and existing industry practices. Therefore, we do not have any examples to provide.

<ESMA\_QUESTION\_PHDG\_10>

1. 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>

No. This would lead to inventory risk by the market participant and might be a case of front-running, depending on the individual circumstances.

<ESMA\_QUESTION\_PHDG\_11>

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

<ESMA\_QUESTION\_PHDG\_12>

The type of financial instruments used for pre-hedging purposes vary on a case-by-case basis. In fact, all financial instruments may be used to pre-hedge, therefore we do not consider any financial instrument should be excluded for pre-hedging purposes.

<ESMA\_QUESTION\_PHDG\_12>

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

<ESMA\_QUESTION\_PHDG\_13>

A key indicator would be adequate client disclosure, in which clients should be aware that pre-hedging may be used on RFQs. However, the absence of such disclosure should not immediately be presumed as illegitimate pre-hedging. In addition, it should laid down in no. 41 (of “4.2.3 Interest of the client”) that a sole benefit for the client also exists if a possible pre-hedging (in line with the agreement, ahead of the trade) facilitates the conditions offered to and accepted by the client.

We disagree with point 3) in no. 39 (of “4.2.3 Interest of the client”) that pre-hedging is considered legitimate if the transaction is in the interest of both the client and the liquidity provider, particularly if this interest refers to financial interest. While pre-hedging could result in improved risk management, it is difficult to quantify or determine financial interest outcomes.

<ESMA\_QUESTION\_PHDG\_13>

1. 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>

The obtainment of express consent is case-specific and cannot be applied or expected for all contexts.

We agree that client’s consent to pre-hedging can be presumed as legitimate behaviour, however, its absence cannot be immediately presumed as illegitimate. Market participants already currently provide adequate disclosure to clients as part of existing market practice. We do not see a need to impose an express requirement to obtain consent to pre-hedging.

<ESMA\_QUESTION\_PHDG\_14>

1. 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>

Practices such as using information, for example about a client’s intentions, to trade to benefit a liquidity provider when the liquidity provider does not intend to execute the transaction, could be considered as illegitimate.

<ESMA\_QUESTION\_PHDG\_15>

1. 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>

This depends on the level of automation of trading, and it could disadvantage smaller liquidity providers if they had to provide this which might reduce market liquidity especially in more specialized instruments. Furthermore, we note that firms already have existing record keeping obligations under MAR and MiFID where applicable. It would not be necessary to impose additional, prescriptive burdens on firms relating to their pre-hedging activities, given that there are regulatory frameworks that adequately and appropriately cover such activities.

<ESMA\_QUESTION\_PHDG\_16>

1. 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>

We do not think that liquidity of a financial instrument should be considered as an indicator. The prime indicator is the intention behind pre-hedging – to provide a very good price to clients for their benefit. This is the main indicator against market abuse.

<ESMA\_QUESTION\_PHDG\_17>

1. 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>

We commonly see such practices with large trades that exceed top of book liquidity. These mainly concern wholesale markets or professional clients, not retail clients.

<ESMA\_QUESTION\_PHDG\_18>

1. 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>

Under the MiFID framework, firms are required to maintain conflicts of interests policies and procedures, which sufficiently address and manage such conflicts where a firm is conducting pre-hedging.

<ESMA\_QUESTION\_PHDG\_19>

1. 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>

Market participants ensure that sufficient disclosure of pre-hedging is made to clients, though there is no universal market practice of pre-hedging disclosure.

<ESMA\_QUESTION\_PHDG\_20>

1. 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>

There is no common market practice where clients are offered a certain number of quotes – this is largely driven by their preference where some clients may request two prices and others will not. We caution against any guidance on the provision of quotes to clients with or without pre-hedging, as it would not be feasible under certain circumstances or for reasons of risk management to offer a non-pre-hedged price.

<ESMA\_QUESTION\_PHDG\_21>

1. 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>

Firms are already subject to reporting and record keeping obligations under existing regulatory frameworks such as MiFID and MAR. Additional prescriptive guidance or requirement for further recordkeeping would be disproportionate and would not result in any significant benefits.

<ESMA\_QUESTION\_PHDG\_22>

1. Would you like to highlight any specific issue related to the obligation to provide clear and not misleading information?

<ESMA\_QUESTION\_PHDG\_23>

We do not see any specific issues.

<ESMA\_QUESTION\_PHDG\_23>

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

<ESMA\_QUESTION\_PHDG\_24>

Pre-hedging by a systematic internaliser (SI) is done on its own books. When replying to RFQs the SI has no certainty that the client will in fact trade with that SI. In the case that the client does not trade with the SI, that SI has an open position on the books.

<ESMA\_QUESTION\_PHDG\_24>