Response Form to the Call for evidence on pre-hedging

29 July 2022 ESMA | ESMA 70-449-674

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 under the heading 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.

General information about respondent

Name of the company / organisation	Bundesverband der Wertpapierfirmen (bwf)
Activity	Investment Services
Are you representing an association?	☒
Country/Region	Germany

Questions

Q1 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>
bwf comment:

The Bundesverband der Wertpapierfirmen e.V. (bwf) is a trade association representing the common professional interests of securities trading firms, market specialists acting as market makers at securities exchanges and/or as systemic internalisers and various other investment firms throughout Germany. In this capacity, we expressly welcome the possibility to comment on ESMA's "call for evidence on pre-hedging".

ESMA correctly states in paragraph 1 that "the practice of pre-hedging is not defined by EU law". Even more, in the 2019 ESMA MAR REVIEW CP which seems to gave the occasion for the questions raised in EFSA's CFE, ESMA referred in paragraph 99 to "practices commonly referred to <u>by some market participants</u> (emphasis added) as pre-hedging and anticipatory hedging." Even though the term is used and defined within the Global FX Code by the Global Foreign Exchange Comittee" (GFXC) as a joint initiative by the industry and central banks it must be noted – without questioning in any way the high quality of work provided – that the comittee has no legislative capacity and that its focus of activities is limited to the FX markets.

Therefore, we would like to add that the term "pre-hedging" not only lacks a valid legal definition but is not even commonly used in the financial market "jargon" across all EU member states. We therefore find it difficult and in the end inappropriate for ESMA to ask whether stakeholders agree with the proposed definition, which then potentially would lay the basis for a new potentially prohibitive regulatory provision. Not only is the term "pre-hedging" up to now not widely prevalent within the German market, even more, it contains a semantic ambiguity: Does it mean an activity prior to hedging activities or hedging taking part prior to the transaction to be hedged? Even though ESMA's conceptional explanations clearly support the latter interpretation, we think that it's semantic opacity already disqualifies the term itself from potentially being used in a prescriptive regulatory context.

When ESMA states in paragraph 5 CFE that "pre-hedging is generally understood as a form of <u>hedging of inventory risk</u> (emphasis added) in an anticipatory manner in presence of a potential incoming transaction", it refers to the – also from a regulatory point of view – generally agreed fact that "liquidity providers" could not efficiently and economically fullfill their function if they were not allowed to manage their "inventory" in an anticipated manner, which includes the opening and closing of positions ("long" or "short") in anticipation of future transactions/market developements.

One of the legitimate reasons to do so, might indeed be based on a risk management rationale and therefore might be attributed as "hedging", even tough we would argue that the anticipatory, "ex ante" creation of a position in expectation of future transactions usually would create an "inventory risk" in the first place. However, it is worthwhile noticing that aside from (market) risk consideration, the anitcipatary management of inventory might have other legitimate reasons, e.g. with respect to a lot size transformation in order to minimize transaction costs or simply to insure to be able to settle a transaction which might be concluded at a later stage in securities where liquididy is low and therefore the relevant securities might be hard to obtain. Accordingly, it is generally and also from the regulatory side agreed, that in particular – but not only – in less liquid markets, liquidity providers like market-makers are required and should be enabled to “progressively build up inventory in expectation of future client demand” (cf. BIS, CGFS Papers No 52, Market-making and proprietary trading: industry trends, drivers and policy implications, November 2014, page 10).

This holds true for all market models where liquidity providers play an active part. However, while an anticipatory management of inventory might be described as “pre-hedging” in certain markets and under certain conditions, we would – for the reasons demonstrated above – not agree to generalize the term (let alone to use it as a basis for regulatory intervention across market models).

ESMA itself discribes two situations of such anticipative bahavior (refered to ESMA as “pre-hedging”) in paragraph 8 CFE (using a RFQ as a trading signal to open a position – “case (i)”) and in in paragraph 9 (where a trade proposal was already submitted but the trade has not been agreed by the liquidity provider – “case (ii)”). However, ESMA’s statement at this point is somewhat contradictory since it claims in paragraph 7 CFE that it will focus on both trading practices/cases quoted above , while in paragraph 12 CFE it states that without further explanation that “ESMA does not intend to address the practices described under case (ii) in this CFE.” Even though “market participants are invited to raise any issue in this respect that they deem should be subject to further analysis.”

However, we think that the reason of ESMA’s preliminary selfrestriction is clear and comprehensible taking into account the history of the underlying discussion: Concerns were raised in and in the answers by several respondents to the 2019 ESMA MAR REVIEW CP that the practice of RFQ providers to take a RFQ as a trading signal to build up a position could be problematic from a MAR (frontrunning) and MiFID (conflict of interest) perspective. This very particular and specific question was then labled “pre-hedging” and referred to liquidity providers as such, independently of the underlying market-practice/model.

While we do not share the general concerns regarding the anticipatory behavior of RFQ providers, which nevertheless of course should be dicussed if deemed neccesary, we object the widening of the discussion (with potential regulatory intervention as a result) to situations and marketpractices/models where “pre-hedging” or “anticipated-hedging”/anticipated behavior might be observable and so far did not give raise to any regulatory concern. We therefore urge ESMA to narrow the further discussion in this context to the questions which weere brought up with respect to the RFQ market model. In reverse, if ESMA should come to the conclusion that it also wants to extend the debate to case (ii) (pending orders) or any other circumstances, we think, that while some of our answers provided here are more general in nature, this should not be done – already under fairness considerations – without publishing and inviting comments to one or more seperate CFEs specific to the cases, respectively market practicels/models in focus.

To conclude these general and introductory remarks it might be worth noticing that the willingness of liquidity providers – across asset classes and market models – has signifficantly declined as a result of the financial crisis, increasing capital requirements (also as a result of the financial crisis), the “crowding out effects of agressive asset buyingprograms by central banks during the last years and several other factors. Accordingly, while we are well aware that regulatory intervention is always intended to balance various factors and sometimes conflicting objectives, we think that regulation in general should be extremely careful about implementing new rules which could potentially further constrain market liquidity.<ESMA_QUESTION_PHDG_1>

Q2 Do you believe the definition should encompass other market practices? Please explain.

<ESMA_QUESTION_PHDG_2>
bwf comment:

“No”, if ESMA, based on certain NCA and stakeholder responses to its 2019 MAR REVIEW CP, is of the opinion that certain practices observed in RFQ market models should be examined from a MAR/conflict of interest mamagement perspective, it should do so. At the same time it would be unjustified, inefficient and contraproductive to extent the scope (which ESMA itself proposed to restrain from, cf. paragraph 12 CFE) to each and every situation which in a general understanding might be brought into connection with the – as described above – higly ambiguous, not uniformly used and in some jurisdictions/Member States so far not officially used or even unknown term “pre-hedging”.
<ESMA_QUESTION_PHDG_2>

Q3 Do you agree with the proposed distinction between pre-hedging and hedging?

<ESMA_QUESTION_PHDG_3>
bwf comment:

As mentioned in our answers before, while the term “pre-hedging” might be part of the financial market “jargon” in some markets and jurisdictions, we think that its semantic ambiguity alone disqualifies it to be used as a regulatory/legislative category. “Hedging” in reverse is generally understood as a practice of (fully or in part) neutralising a risk position by entering into a position/contract which has an adverse risk/return characteristic and thereby offsets the original risk.

However, entering in a position in an “anticipatory” or “forward looking” way very often is also based on the rationale to avoide a future risk which is likely to occure (but is still unknown and therefore only can be anticipated in an aproximative way).
<ESMA_QUESTION_PHDG_3>

Q4 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>
bwf comment:

Just like the term “pre-jedging”, the term “last look functionality” does not have a generally accepted meaning and is used only in certain markets. We therefore do not want to make any judgement regarding a “last look funcitionality” in the context of the CFE. In reverse, we do not object a “last look functionality” as such. What we are rather conserned about is, that conclusions which might be valid (or not) for a specific market design might be generalised in an unjustified way.
<ESMA_QUESTION_PHDG_4>

Q5 What is your view on the arguments presented in favour and against pre-hedging?

<ESMA_QUESTION_PHDG_5>
bwf comment:

Since it is part of the CFE to find out, if there is a generally understood and accepted definition of “pre-hedging” (what we think is not the case), we are of the opinion that the question in this form is inadmissible.

However, with respect to the definition which ESMA offered for “pre hedging”, we can only repeat that it is – also from a regulatory perspective – generally agreed that “proactive“ anticipative management of inventory by liquidity providers is not only admissible but desireable and benefits the market as a whole.

It is worth while remembering that this includes also situtations where the liquidity provider, resulting from its activities, is in the posession of inside information but should not be supposed to violate MAR provisions as long as he or she uses this information in a neccessary and legitimate way resulting from its normal course of activities (cf. recital 29 & 30 of Regulation (EU) no 596/2014 on market abuse). <ESMA_QUESTION_PHDG_5>

Q6 In which cases could a foreseeable transaction enable a conclusion to be drawn on its effect on the prices?

<ESMA_QUESTION_PHDG_6>
bwf comment:

Regarding the question, whether a RFQ could be considered to be categorized as “inside information” on a regular basis (which to our impression, the CFE seems to suggest to some extent), we would clearly object such a conlusion.

However, we do not want to rule out that a RFQ in a specific situation could have the quality of an inside information but this needs to be decided on a case by case basis (for more detail, please see also our answer to Q7). <ESMA_QUESTION_PHDG_6>

Q7 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>

bwf comment:

While we do not want to rule out that the trading intention “discovered” by the liquidity provider could have the quality of a “precise information” from a regulatory point of view (with potential consequences for its qualification as “inside information”), we are very hesistant with respect to any generalised asumtion in this context and think that a any judgement regarding the quality of the information provided by a “discovered” trading interest could only be made on a case by case basis, taking the specific situation and various factors into account. Among others, such factors might include indeed the “past commercial relationship” and (from a comprehensive perspective) the “market conditions”, in particular the liquidity of the instrument in question and an anticipated potential market impact when setting the size of the unveiled trading interest in relation to the market liquidity of the instrument.

In this context, one aspect not to be overlooked lies in the circumstance that unlike “information conveyed by a client and relating to the client’s pending orders (emphasis added) in financial instruments” (cf. article 7 (d) of Regulation (EU) no 596/2014 on market abuse), the trading interest unveiled by a RFQ – which might or might not finally result in an order – is (and we think for good reason) not expressly mentioned in the MAR definition of inside information. Accordingly, we would always argue that a RFQ ceteris paribus (with relevant factors like instrument, size, timing, prevailing market conitions etc. being equal) should – also from a MAR or conflict of interest perspecticive – always be regarded as a less substantial/reliable peace of information (by regulators and market participants alike) than an existing pending order which already was placed by a client/market counterpart. Accordingly, the requirements for a RFQ being pozentially characterised as “inside information” under no circumstances should be lower (e.g. by being subject to a higher level of generalisation) than in the case of a pending order in a firm’s order blotter or a market’s order book.

Furthermore, when discussing the quality and characteristic of information represented in a parties trading interest (in particular whether it can be considered “precise” from a regulatory point of view and therefore potentially could be considered as “inside information”), we think that it urgently needs to be reminded that it is expressly acknowledged within the MAR framework that even to the extent that liquidity providers in their normal course of business might become necessarily aware of, respectively in the possession of inside information when buying or selling financial instruments or executing orders, it “should not be deemed to constitute use of such inside information” (cf. Regulation (EU) No 596/2014 on market abuse, recital 30). Therefore, “in order to avoid inadvertently prohibiting forms of financial activity which are legitimate, namely where there is no effect of market abuse, it is necessary to recognise certain legitimate behavior. This may include for example (emphasis added) the role of market makers, when acting in the legitimate capacity of providing market liquidity (emphasis added)” (loc. cit., recital 29).

Since market makers are mentioned only as an example, other liquidity providers than “traditional” market makers such as RFQ providers or liquidity providers performing their activities as part of a “hybrid” or any other market model (as defined by Annex 1, Table 1, RTS 1 & RTS 1 supplementing Regulation (EU) No 600/2014) the acjnowledgement of the favorable role of liquidity providers and the consequent need to recognise their legitimate business, applies to all forms of liquidity providers. Another example where EU legislation has expressly welcomed and protected the function of liquidity provision can be found in form of a market making exemption from the ban of “naked short selling” withing the EU short selling regulation (cf. recital 26 i.c.w. article 17 of Regulation (EU) No 236/2012 on short selling and certain aspects of credit default swaps).

Therefore, we think that it is of utmost importance that the discusion regarding ESMA’s CFE on “pre hedging” must not promote a direction of thought which in the end might result in a reversal of proof, what is and what is not considered a legitimate business practice in the context of providing market liquidity. <ESMA_QUESTION_PHDG_7>

Q8 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>
bwf comment:

As already stated in our answer to Q7, the anticipated market impact resulting from the relation of the size/volume of trading interes and the prevailing market liquidity/general trading activity under normal conditions usually will have indeed a dominant influence regarding the significance of a potential price impact. <ESMA_QUESTION_PHDG_8>

Q9 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>
bwf comment:

Please see our answer to Q1. While we highly appreciate the work of the Global Foreign Exchange Comittee” (GFXC) as a joint initiative by the industry and central banks it must be reminded that it has no legislative capacity and despite some general considerations which are worthwile to be discussed in this context as well its focus of activities is limited to the FX markets and cannot be generalised or used as a blueprint different markets.<ESMA_QUESTION_PHDG_9>

Q10 Can you identify practical examples of pre-hedging practices with/without a risk management rationale?

<ESMA_QUESTION_PHDG_10>
bwf comment:

To the extent that “pre-hedging” refers to a “proactive” inventory management, in particular by taking positions on a firm’s balance sheet in anticipation of future transactions, this can have also non directly (market)risk-management related reasons, e.g. “lot-size transformation” in order to reduce transaction costs or to insure the facilitation of settlement and to avoid fails in less liquid securities where it would be difficult/insecure to find sufficient liquidity to fill a delivery obligation “ex post”.<ESMA_QUESTION_PHDG_10>

Q11 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>
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<ESMA_QUESTION_PHDG_11>

Q12 Can you identify financial instruments that should/should not be used for pre-hedging purposes? Please elaborate

<ESMA_QUESTION_PHDG_12>
TYPE YOUR TEXT HERE
<ESMA_QUESTION_PHDG_12>

Q13 Please provide your views on the proposed indicators of legitimate and illegitimate pre-hedging. Would you suggest any other?

<ESMA_QUESTION_PHDG_13>
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<ESMA_QUESTION_PHDG_13>

Q14 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>
bwf comment:

"No", we hold the view that in general the regulatory/legislative legitamacy of hedging activities should not be judged from the position of a liquidity provider's clients or market counterparts but should focus on the risk-mitigating effect for the (regulated) firm which conducts hedging practices itself. For more detail, please see also our answer to Q15.
<ESMA_QUESTION_PHDG_14>

Q15 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>
bwf comment:

Aside from the, as described above, opaque and for a regulatory purpose not very usueful term "pre-hedging", we think that ESMA is heading completely in the wrong direction, if it – at least indirectly – suggests that the legitimacy of hedging activities should be dependent on the question whether such activites benefit a firm's clients.

Hedging, as a practice to offset risks, is meant to and desireable from a regulatory point of view in the first place because it reduces the risk of failure of a firm or market participant in general. To this extent, hedging might be also beneficial to the clients and to the market as a whole as it reduces the risk client losses (resulting from non-executed and/or unsettled trades) and market disrupts which may result from a failing firm. However, as demonstrated above, the legitimacy of hedging (or risk-mitigating practices in general) should be evaluated independently from any desirable side-effects on clients or other market counterparts.

While, hedging activities by liquidity providers might also have a beneficial impact on clients/market counterparts (even though, they might not even aware of it because the hedging activities are not disclosed to them), e.g. with respect to the reduction of counterparty risk or because hedging migh in some circumstances enables the liquidity provider to offer better prices and narrower quotes. Still, a potential benefit for the clients/market counterparts should not be seen as creteria of legitimacy of hedging practices from a regulatory/legislative point of view. <ESMA_QUESTION_PHDG_15>

Q16 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>
bwf comment:

Definately "no" and as demonstrated above, there is no obligation under the current legislation and it should not be made a requirement, in particular not on a transaction by transaction basis. The administrative burden to be anticipated from such a requirement would result in a significant increase of complexity of reporting requirements and costs which might even have prohibitive effects on the future provision of liquidity and on certain market models or practices as a whole which are not only deemed legitamate but essential and necessary for the functioning of the securities markets within the Union (cf. recitals 29 & 30 of Regulation (EU) No 596/2014 on market abuse and recital 26 of Regulation (EU) No 236/2012 on short selling and certain aspects of credit default swaps).<ESMA_QUESTION_PHDG_16>

Q17 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>
bwf comment:

"No", while liquidity can be a relevant and important factor whether the information contained in a trading interest could be regarded to be "precise" from a regulatory/legislative point of view (for more detail, see our answer to Q7), the legitimacy of hedging activities in general is not and must not be restricted to less liquid financial instruments. In a market economy, the extent, the timing and the instruments used for hedging should be (within the general regulatory boundries set, e.g. by capital requirements and the large expure regime) dependent solely on the "risk appetite" of the liquidity provider (or more in general, the market participant). Accordingly, hedging activities in liquid instruments are not less important from a risk management perspective (even though they might be easier to facility and hedging options migt be available on a lower price) and therefore should have the same legitimacy as hedging activities in less liquid instruments. <ESMA_QUESTION_PHDG_17>

Q18 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>
TYPE YOUR TEXT HERE
<ESMA_QUESTION_PHDG_18>

Q19 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>
TYPE YOUR TEXT HERE
<ESMA_QUESTION_PHDG_19>

Q20 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>
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<ESMA_QUESTION_PHDG_20>

Q21 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>
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Q22 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>
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<ESMA_QUESTION_PHDG_22>

Q23 Would you like to highlight any specific issue related to the obligation to provide clear and not misleading information?

<ESMA_QUESTION_PHDG_23>
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<ESMA_QUESTION_PHDG_23>

Q24 Should ESMA consider any other element with respect to pre-hedging and systematic internalisers and OTFs? Please elaborate

<ESMA_QUESTION_PHDG_24>
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