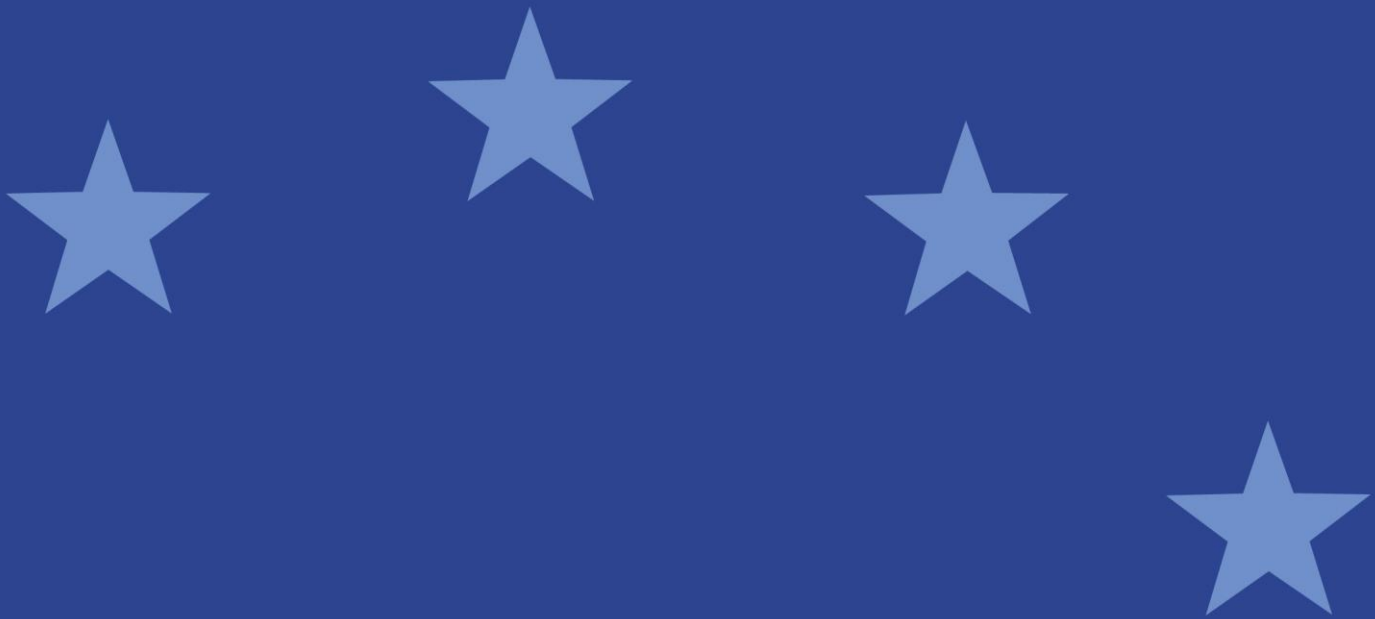


Response Form to the Call for evidence on pre-hedging



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	Deutsche Börse Group
Activity	Regulated markets/Exchanges/Trading Systems
Are you representing an association?	<input type="checkbox"/>
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>

Deutsche Börse Group (DBG) welcomes that ESMA is elaborating this important issue which leads to a necessary discussion of trading practices often referred to as "pre-hedging". However, as we see in this CFE, it might be misleading to define any related trading activity before concluding a transaction as pre-hedging as this term carries legitimation which in some cases is undeserved. Therefore, we agree that the two trading practices mentioned in (i) and (ii) CAN qualify as pre-hedging but not necessarily do in practice, especially case (i).

More specifically, as to our view case (i) effectively refers to a Liquidity Provider (LP) receiving an RFQ and then immediately trading the 'hedge' before they have even submitted a quote back to the requester, or before hitting or lifting a quote supplied by the requester. In this case we would consider it as pure front running because the LP knows that even if they do not win the trade, the LP that does will then have to chase the hedge in the same direction that the front running LP has already traded, effectively allowing the LP to 'lean' on market information that is only available to some participants.

With respect to case (ii) if the LP has either hit/lifted a requester's price or has been hit/lifted by the requester then at any point after this action (even during the "last look" period) executing the hedge in the market is valid pre-hedging because it is done in good faith that a deal will be agreed and concluded.

As a trading venue we are not able to provide as many examples as e.g. market makers (MM) or inter dealer brokers (IDB). However, from our experience investors frequently place orders in financial instruments via IDB who then ask several selected MM (via RFQ or Bloomberg chat etc.) for their prices. These requested MM are then in competition to provide the best price. If one (or more) of these MM decides to trade in the requested (or in any related) instrument before concluding the underlying transaction it must be very carefully assessed whether this qualifies for legitimate pre-hedging or has rather to be seen as front-running to the detriment of clients. In addition, further consideration and clarification regarding "interest/benefit for the client" (see recital 6) might be required due to its open-ended concept and ability of interpretation.

<ESMA_QUESTION_PHDG_1>

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

<ESMA_QUESTION_PHDG_2>

DBG is of the view that the definition should encompass cases where only a single MM for a particular product is in the orderbook and such MM widens the spread after receiving the RFQ. In addition, we would like to reiterate our view that any hedging done after the LP has attempted to deal on a price (including pending "last look" from the requester) is done in good faith and can be classified as pre-hedging.

Furthermore, in order to provide a level playing field, any regulation of pre-hedging by ESMA should not only cover RFQ, but any scenarios in which one market participant discloses its interest buying/selling in a financial instrument selectively to another market participant or limited set of market participants, as with, e.g., Systematic Internalisers (SIs). Any new rules

or guidance should be system and technology agnostic. Otherwise, these rules will not be appropriately scoped, to the detriment of fair and orderly markets and investor protection. An un-level playing field could also shift activity away from regulated RFQ trading venues to SIs and OTC.

<ESMA_QUESTION_PHDG_2>

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

<ESMA_QUESTION_PHDG_3>

DBG agrees with the proposed distinction between hedging and pre-hedging, however, when going through the examples in the table on p.9 we would like to point out that it can only be considered pre-hedging when hedging is done in good faith. The distinction between pre-hedging and front running can be made depending on whether the consent is provided by the client. Thus, the two first examples should be considered as front-running because of the above reasons.

<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>

DBG considers that for the assessment of whether pre-hedging is considered legitimate it should not make a difference if the "last look" is allowed or not. All trades concluded in related instruments before the final transaction took place resp. before a binding agreement, which cannot be amended anymore, is done need to be evaluated in terms of their legitimation.

Please also see more detailed examples below:

If the "last look" is done by the requester once an LP has attempted to deal against a price, this should be certainly considered as pre-hedging, because it is done in good faith that the deal will be agreed, and the hedge is valid.

If an LP has "last look" then it is still a valid pre-hedge, but it is open to manipulation by the LP.

However, if an LP hedges when hit on a quote but then declines the deal via "last look", this is not done in good faith and shall be viewed as front running.

Thus, we agree with ESMA's proposal on this specific trading practice.

<ESMA_QUESTION_PHDG_4>

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

<ESMA_QUESTION_PHDG_5>

Although DBG understands any of the stated arguments, we are of the view that pre-hedging should generally be banned instead of generally being permitted. In other words, as long as not all exactly defined preconditions are fulfilled, it should be treated as abusive market behaviour and thus not be permitted.



Pre-hedging can indeed benefit the requester, but for it to be in good faith, pre-hedging has to be done a) once a deal is agreed, or b) “last look” approval from the requester is pending, or c) at least where LP’s pre-hedging forms part of the agreement.

It can only be considered pre-hedging if full transparency is achieved, it is done in good faith and there are clear rules and requirements that can be traced.

As to p.21, we would like to emphasize that even in liquid or also very liquid assets the LP may still want to be delta neutral on the trade. However, with regards to illiquid markets we see, on the contrary, more risk of abusive pre-hedging practices as such illiquid markets are more likely to be impacted from pre-hedging activities (eg. price movements to the detriment of the customers).

Furthermore, as ESMA is already referencing the approach taken by FINRA (USA) and Canada as well as the GFXC principles in the paragraphs to which this number relates, DBG would welcome that ESMA coordinates (to the extent possibly) any pre-hedging regulation also with other authorities on an international level (esp. USA, UK) in order to provide a level playing field and to avoid a distortion of competition disadvantaging European RFQ system provider and liquidity provider.

<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>

DBG is of the view that the ex-ante information has to be precise (instrument, buy or sell, quantity, time frame). Depending on which market the transaction is planned to be executed, the liquidity of the instrument on that market in relation to the requested transaction quantity is crucial for the assessment of any price impacts, meaning foreseeable transactions volume is significant enough to ‘move the value’ of that product, or correlating product.

Also, the time frame of the execution is important, e.g., when the transaction needs to be concluded outside the main trading time. In addition, the time of execution of any correlating instrument once a foreseeable transaction has presented itself is crucial in order to properly assess if it was not front running. For this to happen the process certainly would need to be fully electronic and exchange surveillance transparent.

<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>

DBG agrees. Typically, LPs will always know which way clients are trading, even if they ask for a two-way price.

<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>

DBG agrees with ESMA that the size of an RFQ should be assessed in conjunction with other factors and variables present in the market at the time the RFQ is submitted, e.g. market conditions (type of trading, time of the day, volatility, any news relevant for the instrument to be traded resp. its underlying) and the liquidity of the specific financial instrument in the market to be traded as well as the size of the hedge required relative to the average volume of the hedging instrument

Additionally, DBG suggests considering concretizing not only the criteria that need to be taken into account when assessing the price sensitivity on a RFQ, but also developing hard and concrete thresholds per criterion. This would be extremely beneficial for legal clarity and would help to monitor violations of this provision on an automated basis.

We also suggest that without full electronification the policing of this will be almost impossible.

<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>

DBG agrees with these cases. However, it should be noted that none of these can be translated into binding rules to legitimate pre-hedging as they are rather soft law and merely guidance information. And even if so, it would be difficult to prove the adherence to them.

Pre-hedging is something that can only be justified if a) it reduces the risk on one's book, or b) where the responder has hit/lifted requester quotes and the LP expects the "last look" approval from the requester/ client that is pending, or c) final exchange validations for an ETD is pending. We would add that it must be in the opposite direction to the strategy risk being put into the book as principal by dealing with the client either directly or via the agent. Also, it does not necessarily have to be the exact amount of opposite risk.

However, 29. a. states 'at the time of transaction'. Please note that this is virtually impossible if it were to be taken literally, and furthermore, we believe that it should be allowed that pre-hedging can take place as part of the example three and four in the table on p.9.

We would also appreciate it if examples were elaborated and provided in relation to 29.c. since it is not clear how or when such a case would occur.

<ESMA_QUESTION_PHDG_9>

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

<ESMA_QUESTION_PHDG_10>

No, DBG cannot identify such examples.

<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>

No, DBG is of the view that under this condition pre-hedging is clearly not legitimated. Pre-hedging can only occur once a deal is agreed (not necessarily concluded) or “last look” approval from the requester/client is pending. In other words. the LP is expecting to deal.

<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>

No, DBG cannot identify such financial instruments. However, it is worth mentioning that any instrument that is not correlated to a strategy/deal that is pending (see Q11 above) cannot be considered as a hedging instrument. According to the same argument, if the instrument is non-correlating, there would be nothing gained by front running the RFQ. The problem arises where the LP front-runs in a correlating instrument, but where there are more suitable correlating instruments because they have a higher correlation or liquidity or both. An LP using one of these instruments would certainly be opening up to claims of front running.

<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>

DBG agrees that the client’s express consent to pre-hedging (ideally in combination with the response/price with pre-hedging and without) could constitute a strong indicator of pre-hedging undertaken in the interest of the client. This consent on a case-by-case basis should therefore be an absolutely necessary part of the rules to be determined for legitimation of pre-hedging.

We believe that a case-by-case client approval is possible to obtain under any circumstances (email, chat, phone, etc.).

<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>

DBG is of the view that ESMA should define communication standards under which such negotiations should take place.

In particular, it shall be mandatory to use only such communication channels which allow for tracking of each part of the relevant communication between client, inter dealer broker and market maker (or any other involved market participant) in order to enable them to prove every single step they have taken (such as seeking client consent for pre-hedging).

This means that the RFQ needs to be electronic, so that it has a tag which if checked allows the LP to pre-hedge according to all four definitions in the table on p.9.

However, a much more suitable solution would simply be to identify pre-hedging as something that can only occur once a deal is agreed (not necessarily concluded) or “last look” approval from the requester is pending. i.e. examples three and four in the previous table. In such a case it would be implicit that a case-by-case consent does not need to be considered, which

otherwise would be a huge burden to not only compliance departments but also to the policing and enforcement of this consent.

As stated above, consent alone cannot be considered as the full justification/legitimation of the pre-hedging activity. It shall be accompanied by the other conditions for a pre-hedging.

<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>

DBG is of the view that such practices can occur when a market participant first does "pre-hedging" then waits long and provides subsequently non-competitive prices with a goal to profit from potential hedging activities from the others while not aiming to win the trade.

Please also see answers to Q3 above with the references to examples three and four in the table on p.9.

<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>

DBG's views are the following:

(i) Yes, if there is a market with some liquidity available. Liquidity providers shall be able to provide market prices valid in the relevant time frame as well as their own offer. Market prices have to consider at least order book depth and volatility. Based on this it shall be possible to evaluate whether to have a real chance to win the trade or not. If no liquidity is in the market, it might be difficult to evaluate this although the responsible market makers should be able to assess it anyway.

(ii) Yes

(iii) Yes, by comparing their potential offers with / without pre-trading

(iv) see answer in Q14

We would also like to emphasize again our views regarding the cases provided to Q3 with the references to the table. The distinction of the examples would help to narrow down the definition of pre-hedging. In addition, we would like to emphasize again that further electronification and clearer rules would improve monitoring.

<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>

DBG believes that although liquidity is a relevant factor, it would make no difference in practice to determine it. The reason is that in high liquid instruments (i) pre-hedging is not necessary

and (ii) frontrunning does not make much sense in terms of the first mover advantage as the expected price movement might be zero or very small only. On the other hand, if the requested quantity is large enough, even liquid instruments could face significant price movements. As such, liquidity of an instrument is only relevant compared to the requested quantity to be traded.

<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>

DBG does not avail of any information about this.

<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 if pre-hedging is conducted?

<ESMA_QUESTION_PHDG_20>

TYPE YOUR TEXT HERE

<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? If so in which instances?

<ESMA_QUESTION_PHDG_21>

TYPE YOUR TEXT HERE

<ESMA_QUESTION_PHDG_21>

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>



TYPE YOUR TEXT HERE

<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>

TYPE YOUR TEXT HERE

<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>

DBG believes there are several scenarios in which one market participant may disclose their interest in a financial instrument selectively to another market participant or limited set of market participants, in addition to RFQs. This is the case where a market participant bilaterally requests a quote from another market participant, for example where a buy-side client bilaterally requests a quote from their salesperson at a sell-side firm. This activity often occurs with Systematic Internalisers (SIs) and over-the-counter (OTC) but is very similar to the way in which market participants request a quote on a trading venue with an RFQ trading system or similar trading system.

In summary, if the focus remains solely on activity on trading venues operating RFQ trading systems rather than more broadly on the activity of one market participant disclosing their interest in a financial instrument selectively to a limited set of market participants, ESMA risks adopting a scope which is too narrow for its guidance. Any new rules or guidance should be system and technology agnostic. Otherwise, these rules will not be appropriately scoped, to the detriment of fair and orderly markets and investor protection. An un-level playing field could also shift activity away from regulated RFQ trading venues to SIs and OTC.

As it was mentioned earlier, we also strongly believe that full electrification with real-time price formation, validation and 'hedging' passing through the platform and available to surveillance functions is crucial. Secondly, the definition of 'pre-hedging' needs to be narrowed down.

<ESMA_QUESTION_PHDG_24>