



**FINANCE
DENMARK**

Response to ESMA call for evidence on pre-hedging

General remarks

Finance Denmark welcomes and supports this initiative from ESMA to develop guidelines on what pre-hedging is. We believe that more clarity will be of the benefit for all market participants.

In the Call for Evidence ESMA refers to the GFXC which we would like to emphasize is a well-function guideline for the FX market.

Pre-hedging is a vital element in order to ensure liquidity in the financial markets, as well as an important tool for a bank or investment firm to effectively manage its risk when acting as a counterparty in its function as a market maker providing liquidity to the market. Pre-hedging is to the benefit of customers by enabling investment service providers to offer competitive pricing and may in certain cases be necessary in order for certain transactions to even be possible to execute. Any regulation and/or guideline in this field should be carefully considered and pre-hedging should not be deemed as misuse of client information, provided that the pre-hedging is performed in pursuit of the legitimate activities in the provision of investment services or as market maker or liquidity provider. We would like to emphasize that if pre-hedging of orders and transactions be further limited, there is an apparent risk that the market for certain financial instruments will disappear to the detriment of the investors and the market.

MiFID II/MiFIR conduct rules include the obligation for investment firms to act honestly, fairly and professionally in a manner which promotes the integrity of the market (Article 24 of MiFIR) and to act in accordance with the best interest of clients. (Article 24 of MiFID II). This addresses the risk of inappropriate behaviour in the interdealer market and in customer facing activities. Trading venues also conduct monitoring to detect any inappropriate behaviour that may jeopardize the fair and efficient operation of the market. Investment firms is also required to include trading related to pre-hedging activities in its own monitoring and surveillance according to Article 16 of MAR.

In the Danish market pre-hedging is primarily used in the FX market, for which reason the below answers are primarily related to the FX market. That said, it is important to remember there are differences as to how financial markets function and what drives and forms the price across different asset classes, for example FX, Equities, Interest rates, Structured products, Commodities, etc. And even within each of these asset classes, there are huge differences in the dept of the liquidity pool, for example a EUR benchmark government bond vs. a DKK mortgage bond in a closed bond series. These differences need to be reflected and taken into consideration if ESMA proceed with developing a pre-hedging guideline.

Further our below responses takes outset in the type 1 scenario (RFQ) defined in paragraph 7 and 8 on page 9 of the consultation paper, since "ESMA does not intend to address the practices described under case (ii) in this CFE" (paragraph 12, page 9). Many of our responses would have been different if we had taken outset in the type 2 scenario (pending orders) defined in paragraph 7 and 9. We therefore strongly encourage ESMA to publish and run a separate consultation, if ESMA in the future intend to explore whether any guidance should be expanded to also cover case (ii) scenarios.

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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>

Finance Denmark agrees with the proposed working definitions for pre-hedging in case (i) as described by ESMA. We believe that case (ii) should be further clarified, as it covers scenarios with different objectives for both client and dealer.

That said it is important to distinguish between situations where a RFQ is actually received and when the liquidity provider is assuming or expecting it. Pre-hedging as defined in the ESMA call for evidence only relates to actual received RFQs.

Further, it is crucial that the definition of pre-hedging does not include all trading activities in the instrument or related instruments, during the time the RFQ or order is received/on-going. The activities that should be classified should only related to activities that are in fact originating from the knowledge of the order.

Finally, Finance Denmark would like to stress the importance of being very clear when defining pre-hedging. Pre-hedging is solely tied to activities that has a direct correlation to the transfer of information inherent in the RFQ.

<ESMA_QUESTION_PHDG_1>

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

<ESMA_QUESTION_PHDG_2>

Not necessarily, but it is important to define when in the life cycle of a deal, the pre-hedging can be seen to take place. Pre-hedging can take place from the RFQ is received until the liquidity provider receives the actual order from the client.

<ESMA_QUESTION_PHDG_2>

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

<ESMA_QUESTION_PHDG_3>

We agree with the proposed distinction, if the distinction is made on whether any hedging activities takes place before (pre-hedge) or post (hedging) the liquidity providers final trade acceptance, and that it clearly sets the boundaries between activities based on the RFQ itself, and what the liquidity provider otherwise is doing.

<ESMA_QUESTION_PHDG_3>

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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>

When using "last look" we do not see a need for pre-hedging, since the liquidity provider in this situation has reserved the right to change the price/quote. We would also like to refer to principle 17 of the FXGC which specifically states that any trading activity related to an order, during the last look window is not allowed. Pre-hedging would take place before the "last look" and therefore the two are not related.

Further, it is important that the liquidity provider does not use the information for own gain.

<ESMA_QUESTION_PHDG_4>

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

<ESMA_QUESTION_PHDG_5>

Finance Denmark is of the opinion that pre-hedging from a general perspective is a vital element in order to ensure liquidity in the financial markets, as well as an important tool for a bank or investment firm to effectively manage its risk. Pre-hedging is to the benefit of customers by enabling investment service providers to offer competitive pricing and may in certain cases be necessary in order for certain transactions to even be possible to execute.

Finance Denmark believes that pre-hedging is conducted in the interest of and for the benefit of the customer to enable the investment firm to be able to provide a price or quote and ensure successful execution and completion of a transaction.

It is important to note that pre-hedging is a by-product of other transactions which might not be possible to conduct unless it is possible to pre-hedge this risk, for example bond issuances and M&A transactions or illiquid currencies, rates or financial instruments. If a bank would assume risk in a customer transaction that it will not be able to hedge, it would increase risks in the trading book and increase cost of funds. This may discourage banks or investment firms from conducting transactions thus impacting the liquidity and the risks in the whole financial system.

Pre-hedging may not be used by liquidity providers for own gain and may only take place if it doesn't put the client at a disadvantage or disrupt the markets.

<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>

A RFM should not be considered to be sufficiently precise to qualify as inside information. In these situations, an order must be placed before the information can be considered as sufficiently precise.

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<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>

If a liquidity provider can discover the trading intentions of a client, such information may be considered as precise information. That said, a client's trading intentions based on past commercial relationship and market conditions would not, in our opinion, be sufficient to qualify as precise information.

<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?

We agree with ESMA that the size of an RFQ should be assessed in conjunction with other factors such as type of trading, time of day and liquidity. All of these factors may have different impact depending on type of financial instrument, for which reason this should also be taken into consideration. But determine a specific threshold/size in relation to impact on the price of the relevant financial instrument would in our opinion not be possible.

<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>

Finance Denmark is of the opinion there could be other cases that from a risk management perspective could justify pre-hedging. For example, if a liquidity provider is requested to give quotes to a multiple number of clients, the liquidity provider can be forced to withdraw from giving quotes if the liquidity provider cannot pre-hedge the risk. Such a situation can have a negative impact on the liquidity in the market.

One argument in favour of pre-hedging as a reasonable risk management tool, relates to the potential risk the liquidity provider may assume from quoting prices elsewhere while an RFQ is negotiating. As the liquidity provider may end up trading with the customer that has submitted the RFQ; the liquidity provider also is providing prices to other clients, as well as potentially the Interbank market. This entails that the liquidity provider might be at a risk of assuming more risk at any one given time, than the liquidity provider is willing to accept. A natural reaction would be for the liquidity provider to provision less liquidity to the market, in form of quotes and orders, until the actual risk is determined (once the client RFQ has been dealt, or not).

In this case, the liquidity provider is not necessarily doing actual trades in the market based on the RFQ or order, but the supply/demand imbalance the liquidity provider creates may affect the general price formation in the market. It is important to note, that it is not a given fact that the market price may be impacted, and the price would move against the customer on the RFQ, as other liquidity providers' reprice – there are clearly scenarios where this would not happen, mainly based on who the liquidity provider retracts liquidity from.

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<ESMA_QUESTION_PHDG_9>

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

<ESMA_QUESTION_PHDG_10>

Pre-hedging is also for the benefit of the clients, since it contributes to better pricing for the clients.

<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>

If a market participant is aware, that it will not be awarded the transaction, we do not see a legitimate interest in pre-hedging since there is no risk to cover.

<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>

Finance Denmark does not have any comments to this question.

<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>

We are of the opinion that pre-hedging should only be used in relation to risk management purposes and without any disadvantage for the client. A consent from the client to pre-hedge does not alone legitimate a pre-hedge.

<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>

For the FX market it would be possible to pass consent on electronic channels. Generally speaking, clients would engage, electronically, with the dealer

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through three different means:

- 1) Single dealer platform
- 2) Multi dealer platform
- 3) API

In all cases, it would be possible to define a property in the RFQ submission workflow, whereby the client could specify whether they opt in or out.

The discussion on pre-hedging is about protecting the client. If the client explicitly opts into pre-hedging, on the assumption that they will get a better price or higher fill rate, then this should be at the client's discretion to do so.

<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>

Pre-hedging is conducted for both of the above-mentioned purposes. It is in the interest of the client if the liquidity provider can pre-hedge the quote, since it gives the client a better price and it is in the interest of the liquidity provider to manage the risk through pre-hedging.

<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; (ii) 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>

- i) No - the liquidity provider would not know whether they would win an RFQ, or whether the client would even deal in the end.
- ii) No - on a case-by-case basis, we cannot see how a liquidity provider would be able to provide evidence of risk management needs, notwithstanding the liquidity provider's own position, which might be the reason to pre-hedge in the first place.
- iii) No - this would imply that the liquidity provider would be able to calculate the cost for the client with or without the pre-hedge. This is not possible, since it would require a precise knowledge of the market impact of the trades done in the pre-hedging process. This can be statistically described, but not in detail for a specific transaction.
- iv) Yes, for the FX market.

<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>

Yes, we agree that the liquidity of a financial instrument may be used as an indicator in determining whether pre-hedging may be illegitimate behavior.

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<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>

Pre-hedging is primarily used for the wholesale markets. But it can also be used for clients that are eligible counterparties but have requested to be re-categorized as professional client.

<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>

Actual and potential conflicts of interest that may arise when conducting pre-hedging are both identified and addressed in internal policies. As a business association we do not have information about the specific content in such policies.

<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>

If a prior consent is required, we prefer a general disclosure as also used in the FX Global code. But as mentioned above we are in favor of a set-up, where the client shall opt-out if he doesn't want the liquidity provider to pre-hedge in connection with an RFQ.

In the FX market, the use of pre-hedging is discussed in the FXGC, and usually it would be disclosed to clients in a general sense in the dealer's available disclosures. We do not know of instances where it is possible for clients to specify this on order entry.

<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>

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To our knowledge, clients are not offered quotes with and without pre-hedging.

<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>

All trades are recorded today and kept for five years. But if trades related to pre-hedging is required this would not be easy to implement and it will require a not insignificant amount of it-resources.

<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>

Finance Denmark do not have any specific issues to highlight.

<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>

Finance Denmark does not further comments.

<ESMA_QUESTION_PHDG_24>

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