FIA EPTA
EUROPEAN PRINCIPAL TRADERS ASSOCIATION

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FIA EPTA response to ESMA's Call for Evidence on Pre-hedging
(ESMA70-449-672)

Introduction and general principles informing FIA EPTA's response

The FIA European Principal Traders Association (FIA EPTA) represents Europe's leading Principal Trading Firms. Our members are independent market makers and providers of liquidity and risk transfer for markets and end-investors across Europe. FIA EPTA works constructively with policy-makers, regulators and other market stakeholders to ensure efficient, resilient and trusted financial markets in Europe.

FIA EPTA welcomes ESMA's intention to provide more clarity, via future Level 3 guidance, regarding pre-hedging practices in RFQ markets. European RFQ markets have seen significant growth and development over the past years and we believe clarity on the situations where pre-hedging may be inappropriate (or not) will contribute to the greater efficiency and reliability of these markets for all participants.

FIA EPTA members favour trading markets which are open, fair, transparent and competitive, thereby offering choice and efficient outcomes for end-investors while ensuring that these can confidently interact with dealer counterparties while seeking liquidity. In this regard, as a general principle, FIA EPTA members consider that a market structure which favours all-to-all trading in conjunction with appropriately calibrated pre- and post-trade transparency requirements ultimately constitutes the most effective environment for such benefits to crystallise.

From this perspective, FIA EPTA members have welcomed the maturing of European RFQ markets, greatly accelerated by MiFID II, into a truly competitive environment which has increasingly moved away from de-facto bilateral voice trading. European RFQ markets have now generally become a place where end-investors can reap the benefits of interacting, in parallel, with multiple competing liquidity providers to seek the most efficient pricing for executing institutional-size trades. These competitive RFQ models extend from automated, electronic RFQ-based trading platforms to competitive voice and chat based RFQ market models, all providing institutional participants with better execution quality in terms of price, certainty and transparency.

As active participants in European RFQ markets, FIA EPTA members provide liquidity at-scale, and with firm pricing, to institutional end-investors under all market circumstances, including in less liquid products and in highly turbulent markets[1]. In this regard, it is our members' experience that pre-

[1] https://wearemarketmakers.com/wp-content/uploads/2021/11/Turning-the-Tables-on-Liquidity-Provision.pdf

hedging is not a prerequisite in competitive RFQ markets for being able to efficiently provide liquidity at-scale to institutional end-investors.

On the contrary, while increased competition between liquidity providers in European RFQ markets has brought many benefits as set out above, this competition has also increasingly shone a light on the implications of pre-hedging practices in these RFQ markets: as the competitive nature of RFQ markets has increased, consequently the level of certainty for a liquidity provider that they may win a trade has *decreased*. Therefore, it has become less discernable what genuine risk management purpose pre-hedging might serve in such competitive RFQ markets. This, in turn, has also implications from a market integrity perspective, as rigorous tests need to be fulfilled for pre-hedging to be appropriate, given that pre-hedging may imply trading on the basis of price sensitive information. Related to this are also concerns regarding undue price slippage for end-investors in a scenario where multiple liquidity providers would be pre-hedging in parallel triggered by the same request.

As regulatory clarity on these matters has so far been absent, FIA EPTA members are observing disparate trading practices which lead to uncertainty on the part of end-investors, while also causing an unlevel playing among liquidity providers who may or may not feel that pre-hedging in a specific trading scenario may be appropriate or not. Such uncertainty risks partly undoing some of the benefits stemming from healthy competition in RFQ markets. It is for this reason that FIA EPTA members call upon ESMA to provide the needed regulatory clarity via Level 3 guidance.

We set out our further considerations in our responses to ESMA's questions in CFE. Our responses are informed by the principles below, which we would encourage ESMA to integrate into its final proposed guidance:

- **Genuine risk management rationale:** Pre-hedging in RFQ markets is *only* acceptable where a *genuine* risk management rationale is present for the liquidity provider and where any benefits of pre-hedging accrue to the end-investor. However, in competitive RFQ markets, where multiple liquidity providers compete to win a trade from a requesting counterparty/client, it is either impossible or highly unlikely for the liquidity provider to be sufficiently certain that they will indeed win the trade. The presumption in such competitive RFQ markets should be, therefore, that such a genuine risk management rationale is *not* present, unless it can be clearly evidenced, disclosed and consented to, on a trade-by-trade basis.

- **Trade-by-trade disclosure and consent:** Within competitive RFQ markets, where a liquidity provider considers that a genuine risk management rationale is present, the liquidity provider should provide disclosure on a trade-by-trade basis to the requestor, who must consent that pre-hedging is acceptable. The following considerations are critical in this regard:

    - The trader acting for the requestor should be explicitly informed for each individual RFQ that the liquidity provider may pre-hedge and why;
    - The trader acting for the requestor should be enabled to materially assess the implications and provide consent for each individual RFQ whether or not they are willing to allow the liquidity provider to pre-hedge;
    - In no circumstance for an individual RFQ can it be the case that the trader acting for the requesting counterparty is *not* aware that pre-hedging might take place;
    - Generic disclosures or general terms of business are not fit for purpose in this regard and should never be considered sufficient;

- By derogation from the above, where a counterparty/client foresees to be undertaking *multiple linked RFQs on the same trading day*, the disclosure and consent could need to be granted only once for that day only.

- **General market integrity considerations:** Given that the liquidity provider may be in receipt of material price sensitive information, as a consequence of receiving a non-public request-for-quote from their counterparty/client, stringent market integrity controls by the liquidity provider should be in place and inform at all times the liquidity provider's potential use of that information for trading purposes.

- **Pre-hedging in competitive RFQ markets should be the clear exception**, given the strict tests set out above. Firstly, we note that in an automated/electronic, transparent and competitive RFQ trading venue environment, pre-hedging is clearly unnecessary: there is no foreseeable genuine risk management rationale present and additionally trade-by-trade disclosure would be impracticable. Secondly, in other types of RFQ markets where liquidity providers are in competition with each other we fail to see in almost all circumstances how all required tests could be fulfilled. We believe all professional parties to be able to quote firmly and competitively in the current modern market structure, without having to revert to pre-hedging. Thirdly, we do however accept that the tests to possibly allow pre-hedging might be more easily fulfilled for non-competitive bilateral RFQs, while noting that the presence of price sensitive information still requires the application of strict controls over this practice.

We summarise our assessment in regard to the appropriateness (or not) of pre-hedging in RFQ markets in the table below:

	1. Competitive automated / electronic RFQ trading platforms	**2. Competitive voice/chat RFQs (multiple quotes coming in response to a request)**	**3. Bilateral voice/chat RFQs (with no competition among liquidity providers)**
A. Application of trade-by-trade disclosure to, and express consent by, counterparty/client[2]	Not practicable	Practicable	Practicable

[2] As set out in our response to Q14 and Q20: FIA EPTA considers that the following key principles should apply in regard to disclosure and consent:

- That the trader acting for the requestor is explicitly informed for each individual RFQ that the liquidity provider may pre-hedge.
- That requestor should be enabled to materially assess the implications and provide consent for each individual RFQ whether or not they are willing to allow the liquidity provider to pre-hedge.
- In no circumstance for an individual RFQ can it be the case that the trader acting for the requesting counterparty is not aware that pre-hedging might take place.
- Generic disclosures or general terms of business are not fit for purpose in this regard and should never be considered sufficient.

B. Presence of genuine risk management rationale for liquidity provider	None – given level of competition between liquidity providers, making it impossible for a liquidity provider to be genuinely certain that he will win the trade	Highly unlikely to be present, given competitive environment, making it normally impossible for a liquidity provider to be genuinely certain that he will win the trade. However, a genuine risk management rationale might be present in rare exceptional circumstances, which then must be evidenced by the liquidity provider	Likely present given bilateral interaction with certainty of no competition from other liquidity providers
C. Impediments to counterparty/client interests and general market integrity considerations	Present, given that liquidity provider has no certainty that he will win the trade, hence trading on basis of material non-public information received as part of the RFQ would be inappropriate	Present, given that liquidity provider has no, or at best very little, certainty that he will win the trade. Hence trading on basis of material non-public information received as part of the RFQ would likely be inappropriate, unless expressly allowed by counterparty/client on a trade-by-trade basis	Possession of material price sensitive information (from counterparty/client) requires stringent market integrity controls by the liquidity provider (in addition to express consent on a trade-by-trade basis) in order to mitigate market integrity concerns
Appropriateness of pre-hedging based on tests A-C above	Absent[3]	Only in exceptional circumstances where all three tests (A-C) have been materially fulfilled and can be evidenced on a trade-by-trade basis	Potentially, where all three tests (A-C) have been materially fulfilled and can be evidenced on a trade-by-trade basis

Below FIA EPTA outlines specific, technical restrictions that ESMA could consider:

- By derogation from the above, where a counterparty/client foresees to be undertaking multiple linked RFQs on the same trading day, the disclosure and consent could need to be granted only once for that day only.

[3] Except where a third country exchange permits pre-hedging and the activity is done in conformance with the rule and relates only to orders in contracts traded on that exchange, cf. FIA EPTA;s response to Q2.

Q1: Do you agree with the proposed working definition of pre-hedging with respect to cases (i) and (ii)? Please elaborate and provide examples on both instances.

FIA EPTA agrees with ESMA's working definitions for the pre-hedging cases (i) and (ii) and also agrees that it is case (i) (rather than case (ii)) which requires regulatory clarification via Level 3 guidance. I.e., we agree that ESMA's attention should focus on pre-hedging practices where: "a liquidity provider, having received an RFQ from a client but not yet its firm order, pre-hedges the position that it would have to take if it happened to win the trade, prior to the transaction finalisation."

Unless applied in a clearly restricted manner for risk management purposes and in a fully materially disclosed manner, pre-hedging in RFQ markets may in our view compromise the applicable market integrity objectives for investors and the wider market. We ask, therefore, that ESMA publish clear guidance on the conditions under which pre-hedging under case (i) is, and is not, permissible, specifically within competitive RFQ markets (across electronic, chat and voice protocols) where multiple dealers are in competition with each other to win a trade.

Further, we note ESMA's interchangeable use in the CFE of both terms "client" and "counterparty". We agree that it is important not to distinguish between these two categories for the purpose of this CFE, as well as for possible future ESMA guidance on pre-hedging. This comprehensive approach will be beneficial both from a market integrity and a level playing field perspective, through the inclusion of all possible trade scenarios where a firm dealing on own account interacts with third party trading interests through the reception of an RFQ, irrespective of whether the parties initiating the RFQ are being categorised as "clients" or "counterparties".

Q2 Do you believe that the working definition of pre-hedging should encompass other market practices? Please explain

In FIA EPTA's response to ESMA's Consultation Paper on its MAR review report, we set out various trading scenarios that we considered to fall into the "legitimate market making" category under MAR and asked that ESMA provide guidance as to whether these activities could be pursued when a market maker is in possession of such RFQ information. Our comments at the time were derived from FIA EPTA's members' observations in regard to competitive RFQ markets generally (across trading protocols). However, we more specifically considered trading practices in an electronic trading venue environment. While we still fully stand behind our 2019 comments, we would note that our comments in response to the current CFE expand in more detail on how FIA EPTA members view the appropriateness or not of pre-hedging in other competitive RFQ trading protocols.

We noted in our 2019 comments that in "FIA EPTA's view, it is only acceptable to pre-hedge in the limited circumstances set out in paragraph 6(a), 6(b) and 6(c) below where a clear risk management rationale is present, and the pre-hedging does not impede on counterparty/client interests and general market integrity considerations."[4].The relevant excerpt from the response is reproduced below for ESMA's convenience. We note that (a) and (b) below relate to the activity in paragraph 9 of the CFE (i.e., Case (ii) pre-hedging activity) and therefore are not relevant to this response as ESMA is not considering that activity in this CFE:

[4] FIA EPTA Response to ESMA's Consultation Paper on its MAR Review Report (November 2019), Q22 (pp 12-16 here: https://www.fia.org/sites/default/files/2019-12/20191129_FIA%20EPTA_Response%20to%20the%20ESMA%20consultation%20on%20MAR_FINAL.pdf)

"6. MAR sets out to "avoid inadvertently prohibiting forms of financial activity which are legitimate, namely where there is no effect of market abuse". It recognises that "This may include, for example, recognising the role of market makers, when acting in the legitimate capacity of providing market liquidity." Further ESMA guidance on what constitutes legitimate market making in the context of RFQ trading has not been issued to date. FIA EPTA would welcome the issuance of such guidance. Whilst we believe, as set out above, that pre-hedging where no clear risk management rationale can be evidenced should be clearly prohibited, we consider, by contrast, that the following practices are legitimate market making activities in the context of RFQ trading:

a. Where following a request for a price from a counterparty there is an agreed understanding with the counterparty, the market participant agrees with the counterparty to trade at a stated reference price on the basis that the market participant is allowed to hedge in advance of the calculation of that price. This could be pursuant to an explicit agreement at the time of trading or pursuant to an agreed course of dealing between the counterparties. For example, a market participant guarantees that a counterparty can buy at an ETF's NAV on the basis that the participant is allowed to buy the constituents of the underlying ETF or other related hedge ahead of the calculation of that NAV. This practice should be permitted because it is done with the consent of the investor and it enables the investor to get a better fill than would otherwise have been available had the market maker not been able to pre-hedge;

b. Where following an agreed understanding with a counterparty the market participant indicates that he will trade at a particular price or better if they are allowed to pre-hedge. For example, in the options market an options market maker may agree with a counterparty that they will trade with him at a particular volatility level on the basis that the counterparty agrees that the market participant may execute their "delta hedge" in the underlying instrument before the final options price is determined. This practice should be permitted because it is done with the consent of the investor who, in this case, cares most about the volatility component of the options trade price. Agreeing that the market marker may execute a hedge in the instrument underlying the option enables the investor to get a better fill than would otherwise have been available had the market maker to assume the risk with respect to the price at which the delta hedge could be executed as well as the risk with respect to the volatility component of the options price;

c. Where a third country exchange (hereafter "TCE") permits pre-hedging and the activity is done in conformance with their rules and relates only to orders in contracts traded on that exchange. This, however, would not permit a market participant to use information about orders in instruments admitted to trading on a regulated market to trade in contracts on the TCE in circumstances which otherwise would not be permitted by MAR. For example, a market participant could not use information about an order in a ETF which is admitted to trading in Europe but which has an underlying index which is the S&P 500 to trade in S&P 500 futures on CME other than in accordance with the guidance set out in paragraphs 6(a), (b) and (d) to (i)

d. Where following the receipt of an RFQ the market maker continues to update their quotes in line with moves in the displayed market quotes but not based on the information that they have received. This should be permitted in order to ensure the continuity of liquidity provision in the market;

e. Where following receipt of an RFQ which they fill the market maker is free to trade notwithstanding the fact that the trade may not be public as yet. This should be permitted as the market maker has assumed risk and should be free to hedge that risk. The investor has been filled and cannot be prejudiced by the market makers actions;

f. Where following receipt of an RFQ a market maker widens out their quote or pulls their quote to protect themselves against persons who may misuse the information. This should be permitted as a prudent risk management measure for market makers who are particularly exposed to bad behaviour from other market participants because of their requirements to post two-way prices continuously.

g. Where following the receipt of a RFQ a market maker is notified that the order has been filled elsewhere the market maker is free to update their prices to reflect the information even though that trade may not have been published. This should be permitted as the investor is filled and cannot be prejudiced by the market maker's actions. The market maker should be free at that stage to incorporate information regarding the fact that securities have been bought or sold and the volumes and prices of those acquisitions into its liquidity provision activities;

h. Where following receipt of an RFQ which is not immediately filled by the market maker a reasonable period of time has passed by such that the counterparty has had a reasonable opportunity to execute the order the market maker is free to update their prices to reflect the information. The reasonableness of the length of time is determined by factors such as the liquidity of the market;

i. Where following the receipt of an RFQ which is not immediately filled by the market maker, the market maker receives a RFQ with the opposite direction to the first RFQ, the market maker may improve its price for the second RFQ and may deal whilst having knowledge of the first RFQ. The legitimate activity of a market maker involves provision of immediacy to investors thereby bridging the gap between buyers and sellers. In this case the market maker has improved the price given to an investor using the knowledge that another investor has interest in the opposite direction. The market maker may thereafter also be able to offer to deal with the initial price requestor at a better price than that initially quoted."

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

Yes. FIA EPTA members agree with ESMA's statement in paragraph 11 of the CFE that hedging is an activity that take place *after* the liquidity provider has internalised the risk stemming from a trade with a counterparty. This sets hedging logically apart from pre-hedging which is an activity taking

place *before* the liquidity provider has internalised this risk. We further consider that the activities in the first three columns of the table in paragraph 16 should be considered to be in the category as referred to in paragraph 8 of ESMA's CFE ("Case (i)" pre-hedging trading practices). The category in column 4 should be considered to be in the category as referred to in paragraph 9 of the CFE ("Case (ii)" pre-hedging trading practices). In line with ESMA's view that "Case (ii)"activities are outside of the scope of the CFE we consider that the practice in column 4 should not be considered in this CFE.

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'?

"Last look" practices give rise to their own concerns. We do not believe that those issues should be discussed in the context of the current work on pre-hedging and may only serve to complicate the issue.

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

Unless applied in a clearly restricted manner for risk management purposes and with active trade-by-trade consent by the responsible requestor, 'Pre-hedging' in competitive RFQ markets (whereby requestors seek multiple quotes in parallel from competing liquidity providers) may in FIA EPTA's view compromise the market integrity objectives for investors and the wider market, irrespective of RFQ trading protocol used (automated/electronic, chat or voice).

FIA EPTA members note that a concern for investors is that there may be information leakage during the RFQ process, i.e., the concern that market participants may take advantage of the investor's price requests in order to make trading profits and, in the process, move prices against the investor. For example, were an investor to ask for a price from a number of market makers (either directly or indirectly through an agency or inter dealer broker) and each market maker concluded on receipt of the price request that it was likely that they were going to win the trade and therefore pre-hedged, this could increase price slippage costs for investors and consequently undermine confidence in the market. Where only one market maker were to do this and others not it, would become a self-fulfilling prophecy i.e., the market maker who had pre-hedged would be moving the price of the hedge against the other market makers, meaning that they would be forced to quote a worse price to the investor thereby ensuring that the party who pre-hedged would win the trade. Such practices may create an un-level playing field and distort competition among market makers

We are broadly in agreement with the arguments against pre-hedging articulated in Section 3.1 of the CFE. We would also include as an argument against pre-hedging the rules in relation to Solicited Transactions under the OCC exchanges. For example, CBOE Rule 5.86(e)[5] provides as follows:

"(e) Trading based on knowledge of imminent undisclosed solicited transaction. It will be considered conduct inconsistent with just and equitable principles of trade and a violation of Rule 8.1 for any Trading Permit Holder or person associated with a Trading Permit Holder, who has knowledge of all material terms and conditions of an original order and a solicited order, including a facilitation order, that matches the original order's limit, the execution of which are imminent, to enter, based on such knowledge, an order to

[5] https://cdn.cboe.com/resources/regulation/rule_book/C1_Exchange_Rule_Book.pdf

buy or sell an option of the same class as an option that is the subject of the original order, or an order to buy or sell the security underlying such class, or an order to buy or sell any related instrument until either (1) all the terms and conditions of the original order and an changes in the terms and conditions of the original order of which that Trading Permit Holder or associated person has knowledge are disclosed to the trading crowd or (2) the solicited trade can no longer reasonably be considered imminent in view of the passage of time since the solicitation…."

FIA EPTA further noted ESMA's references to other global regimes that address various pre-hedging scenarios in specific markets or asset classes. In this regard, we have the following comments**:**

FINRA Rule 5270

It is FIA EPTA's informed understanding that FINRA Rule 5270 should not be read as an argument in favour of pre-hedging as defined by ESMA in Case (i) but, rather, offers a narrow exception for the conduct set out by ESMA in Case (ii). We note that FINRA Rule 5270 states**:**

> **"** No member or person associated with a member shall cause to be executed an order to buy or sell a security or a related financial instrument when such member or person associated with a member causing such order to be executed has material, non-public market information concerning an imminent block transaction in that security, a related financial instrument or a security underlying the related financial instrument prior to the time information concerning the block transaction has been made publicly available or has otherwise become stale or obsolete."

We read the exception to the above rule to be relating to situations described in paragraph 9 of the CFE ("Case (ii)" pre-hedging activity), i.e., circumstances where the dealer has been awarded a trade and is hedging ahead of the time that the price of the block trade is struck or for a situation where the dealer has consummated the trade but before the trade has been printed on the tape.

Canadian Universal Market Integrity Rules IIROC Rule 4.1

In FIA EPTA's understanding, IIROC Rule 4.1 prohibits pre-hedging as described in paragraph 8 of this CFE ("Case (i)" pre-hedging activity). As ESMA itself observes *"The Canadian Universal Market Integrity Rules ban the practice of front-running a client order."* The Rule states:

1. "A Participant with knowledge of a client order that on entry could reasonably be expected to affect the market price of a security, shall not, prior to the entry of such client order:

- enter a principal order or a non-client order on a marketplace, foreign organized regulated market or other market, including any over-the-counter market, for the purchase or sale of the security or any related security;
- solicit an order from any other person for the purchase or sale of the security or any related security; or
- inform any other person, other than in the necessary course of business, of the client order
- inform any other person, other than in the necessary course of business, of the client order"

There is an exception to this rule that would appear to permit a person who had a position *prior* to receiving order information to still hedge that pre-existing position in the normal course of business

after receiving the order information. This, however, would not constitute pre-hedging as contemplated in paragraph 8 of the CFE. [6]

In regard to ESMA's references to the standards for the FX and FICC markets, we note that it could be argued that these markets can be more based on bilateral negotiation. Therefore, there may be an argument in favour of pre-hedging where there is more of an opportunity for bilateral discussion and the pre-hedging activity is fully transparent to the counterparty or client to provide consent on a trade-by-trade basis for the liquidity provider to carry out pre-hedging.

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

FIA EPTA agrees with ESMA that requests for quotes may meet the definition of inside information in that they can be both non-public and precise. We note that trading venues that make use of the RFQ facility normally make RFQs only visible at the time of the request to the market makers who have been asked to respond to the RFQ. Consequently, these specific requests are non-public at the time of receipt and will only become public once the quote(s) by the market maker(s) provided in response to the RFQ have been made pre-trade transparent under the rules of the venue. Pending the application of pre-trade transparency such non-public quoting requests may also constitute precise information, in particular, where the size and the side of the trade are "opened" by the client or counterparty (i.e., when the client or counterparty is requesting a one-sided quote for a specific size). Such information may also be specific enough to enable a conclusion to be drawn on its effect on the prices of the financial instrument concerned or related financial instruments. Please also see our remarks with respect to "polling" in Q7 and the scope of financial instruments in Q12.

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?

FIA EPTA members consider that a request for a two sided quote is unlikely to contain enough precise information to constitute inside information. There may be situations where, on a case by case, other pieces of information may be present that was known to the market maker about the counterparty's or client's interest at the time the quote was requested (e.g., other information about the client/counterparty or instrument which may allow the market maker to infer the direction of the trade). Additionally, it should be noted that where it is clear that a party (such as an inter-dealer broker) is just seeking information for the purposes of conveying pricing to another party who may or may not be interested in trading this is not inside information. CESR previously referred to this activity in its level 3 guidance as "polling". [7] Market makers also often receive electronic RFQs that are not indicative of true trading interest and such RFQs should be disregarded for this purpose.

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[6] IIROC, Rule 4.1 (2) (d): "a principal order is entered to hedge a position that the Participant had assumed or agreed to assume before having actual knowledge of the client order provided the hedge is:
commensurate with the risk assumed by the Participant, and entered into in accordance with the ordinary practice of the Participant when assuming or agreeing to assume a position in the security.

[7] Market Abuse Directive, Level 3, Second set of CESR guidance and information on the common operation of the Directive to the market, July 2007, at paragraph 3.8, available at: https://www.esma.europa.eu/sites/default/files/library/2015/11/06_562b.pdf

We would caution, however, against creating open ended regulatory definitions with concepts such as "past commercial relationships" as this could cause legal uncertainty.

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?

FIA EPTA members consider that the factors that should be considered are mentioned in paragraph 21 of the CFE which will likely determine whether an RFQ is likely to have a significant effect on the price of the relevant financial instruments and related derivatives. These include the size of the RFQ in relation to the liquidity of the underlying instrument.

Q9: Does the GFXC Guidance describe all the possible cases of risk management rationale that could justify legitimate pre-hedging? If not, please elaborate

Please also see FIA EPTA's answer to Q5 concerning practices in the FX market and MIFID II/MAR. In FIA EPTA's view, it is only acceptable to pre-hedge in the limited circumstances set out in our answer to Q2.

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

Please see FIA EPTA's answer to Q2

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?

No. Please see FIA EPTA's answer to Q2 above. Pre-hedging where the market participant is aware that it will *not* be awarded the transaction is certainly not acceptable. Separately, in competitive RFQ markets, participants must have strong objective reasons, which normally would be unlikely to exist, to believe that they will be exposed to risk in order for pre-hedging to be permissible as pre-hedging should only take place in a very limited amount of scenarios where a clear risk management rationale exists and the client/counterparty has provided express consent on a trade-by-trade basis.

12: Can you identify financial instruments that should/should not be used for pre-hedging purposes in specific circumstances? Please elaborate

FIA EPTA members consider that the restriction on pre-hedging should be considered to be a prohibition on trading in the financial instrument to which the order relates and any related financial instruments. For example, a recipient of a price request in an ETF based on the DAX index should be precluded from trading in the ETF itself and the underlying constituents.

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

Please FIA EPTA's answer to Q2 above.

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?

FIA EPTA members consider that it is paramount that counterparties or clients are fully aware that pre-hedging may take place before it actually takes place, so they have the opportunity to oppose it or agree on the terms and conditions of such activity. This transparency should be provided on a trade-by-trade basis.

Within competitive RFQ markets, and where a liquidity provider considers and can evidence that a genuine risk management rationale is present, it is FIA EPTA's strong belief that the key principle that should apply in regard to disclosure and consent is that the requestor (i.e., the responsible buy side trader, or the sell side trader where an end-investor is acting through a broker), is explicitly informed for each individual RFQ that the liquidity provider may pre-hedge.

In other words, FIA EPTA considers is it of fundamental importance that the liquidity provider should provide disclosure on a trade-by-trade basis to the requestor, who must consent that pre-hedging is acceptable. The following considerations are critical in this regard:

- The trader acting for the requestor should be explicitly informed for each individual RFQ that the liquidity provider may pre-hedge and why;
- The trader acting for the requestor should be enabled to materially assess the implications and provide consent for each individual RFQ whether or not they are willing to allow the liquidity provider to pre-hedge;
- In no circumstance for an individual RFQ it can be the case that the trader acting for the requesting counterparty is not aware that pre-hedging might take place;
- Generic disclosures or general terms of business are not fit for purpose in this regard and should never be considered sufficient;
- By derogation from the above, where a counterparty/client foresees to be undertaking multiple linked RFQs on the same trading day, the disclosure and consent could need to be granted only once for that day only.

We finally note that given how competitive, automated RFQ market models in electronic trading venues operate, trade-by-trade disclosures cannot be provided in a practicable manner in such an environment. This is a secondary reason (in addition to the absence of a clear risk management rationale, which is the fundamental consideration) why FIA EPTA is of the view that pre-hedging within such competitive, automated, electronic RFQ models is inappropriate.

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?

Please see FIA EPTA's answers to Q1 and Q5 above.

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.

Please see FIA EPTA's answer to Q2 which sets out the limited circumstances in which FIA EPTA believe pre-hedging should be permitted if there is a risk management rationale. As alluded to in our response to Q14, we do not believe it is generally feasible in markets where there are multiple dealers in competition, such as electronic RFQ markets, for liquidity providers to provide evidence of the above. However, if ESMA were to permit pre-hedging more widely, that it should be on a trade by trade basis, subject to the conditions we set out in our response to Q14, so as to make it possible to provide evidence of the transparency for the counterparty or client. It would also be possible in these circumstances to give the counterparty a quote on a pre-hedged and not pre-hedged basis which would evidence the benefit for the client. Please also see our answer to Q5.

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.

FIA EPTA members consider that liquidity of the financial instrument should not be the main consideration but rather the material market structure context in which the pre-hedging would occur.

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 orders / RFQs submitted by retail or professional clients?

n/a

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.

n/a

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?

FIA EPTA members do not believe that currently there is any uniform market practice with respect to pre-hedging or to the disclosure thereof. We consider that this causes counterparties and clients currently to be underinformed regarding the nature and impact of pre-hedging activity in European markets and we urge ESMA to address this situation via Level 3 guidance.

As per our answers to Q5 and Q14, disclosures must be fully transparent to allow the trader acting for requesting counterparties/clients to oppose to it or agree on the terms and conditions of such activity. We do not believe that it is appropriate to address this issue solely through reliance on the disclosure standards under the MiFID Conduct of Business Rules as it entails a matter of market integrity. Equally, and the ability to pre-hedge in an RFQ context should not rest on how the initiator of the RFQ may be categorised (as either a client or counterparty). Please also see the first paragraph of our answer to Q1 and our response to Q5 and Q14, with the latter repeated below for clarity:

Within competitive RFQ markets, and where a liquidity provider considers and can evidence that a genuine risk management rationale is present, it is FIA EPTA's strong belief that the key principle that should apply in regard to disclosure and consent is that the requestor (i.e., the responsible buy side trader, or the sell side trader where an end-investor is acting through a broker), is explicitly informed for each individual RFQ that the liquidity provider may pre-hedge.

In other words, FIA EPTA considers is it of fundamental importance that the liquidity provider should provide disclosure on a trade-by-trade basis to the requestor, who must consent that pre-hedging is acceptable. The following considerations are critical in this regard:

- The trader acting for the requestor should be explicitly informed for each individual RFQ that the liquidity provider may pre-hedge and why;
- The trader acting for the requestor should be enabled to materially assess the implications and provide consent for each individual RFQ whether or not they are willing to allow the liquidity provider to pre-hedge;
- In no circumstance for an individual RFQ can it be the case that the trader acting for the requesting counterparty is not aware that pre-hedging might take place;
- Generic disclosures or general terms of business are not fit for purpose in this regard and should never be considered sufficient;
- By derogation from the above, where a counterparty/client foresees to be undertaking multiple linked RFQs on the same trading day, the disclosure and consent could need to be granted only once for that day only.

We finally note that given how competitive, automated RFQ market models in electronic trading venues operate, trade-by-trade disclosures cannot be provided in a practicable manner in such an environment. This is a secondary reason (in addition to the absence of a clear risk management rationale, which is the fundamental consideration) why FIA EPTA is of the view that pre-hedging within such competitive, automated, electronic RFQ models is inappropriate.

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?

n/a

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?

n/a

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

n/a

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

n/a