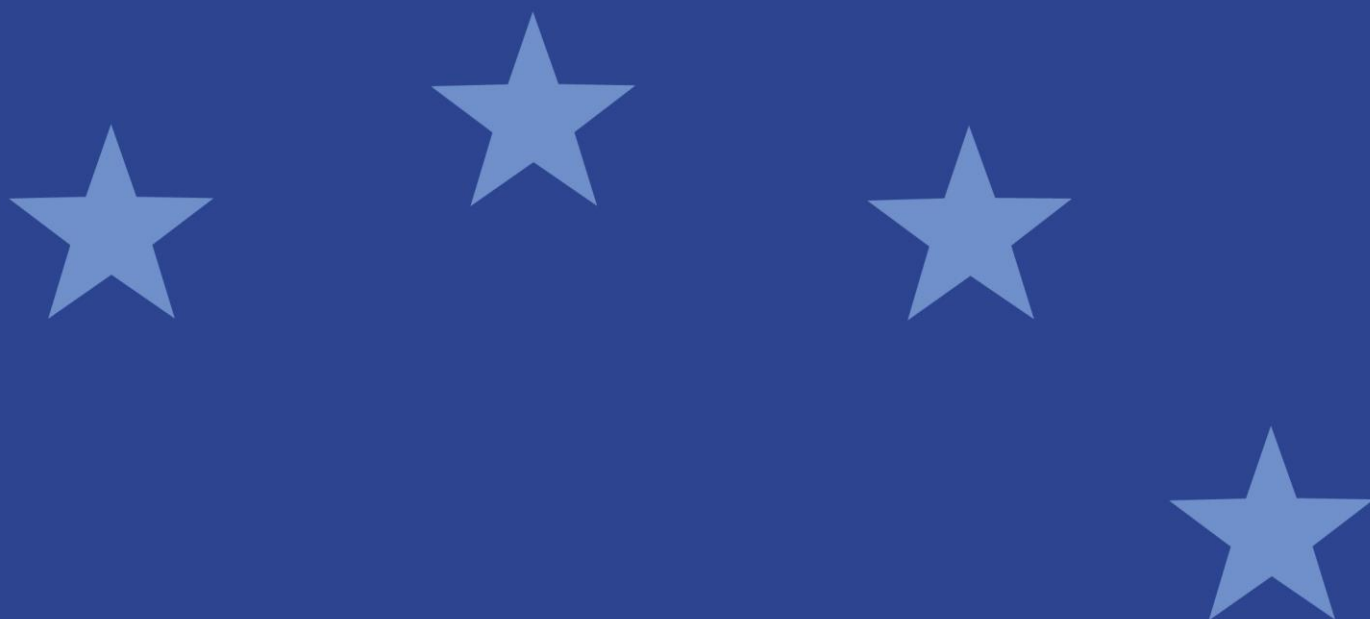


Response Form to the Call for evidence on pre-hedging



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	AFME
Activity	Other Financial service providers
Are you representing an association?	<input checked="" type="checkbox"/>
Country/Region	UK

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>

We fully support the existing definitions and guidance relating to pre-hedging set out in the Global FX Code (“**GFXC**”), the FMSB Standards on large trades in FICC markets and the Global Precious Metals Code, which collectively reference a range of factors considered by firms, and are of the view that it is unnecessary to provide further definitions and guidance on this topic for products already in scope of such guidance. Should other industry bodies consider introducing guidance for other markets, we would welcome the opportunity to engage in discussions and further consultation with them.

In the context of the definitions set out in the CFE, while the working definition of pre-hedging makes reference at point (ii) to mitigating an inventory risk, case (i) and the CFE goes on to refer to pre-hedging in the context of managing the risk of single transaction, rather than inventory risk on a more holistic basis. We assume, therefore, that hedging on an inventory basis is outside the scope of this CFE and our responses are provided on that basis.

While we note that case (ii) is not addressed by ESMA in the CFE, we do not agree that case (ii) is pre-hedging. This is because under case (ii) the risk being hedged is known since the order is already pending and therefore it would not be considered pre-hedging, a prerequisite of which is that the risk being hedged is uncertain. Therefore ESMA should limit its working definition of pre-hedging to case (i) only. Additionally, we assume that in case (ii) ESMA is referring to reference price transactions, which in our view are outside the scope of this CFE and should be outside the scope of any guidance provided by ESMA on pre-hedging, and should ESMA wish to further explore pre-hedging under case (ii) we would welcome the opportunity to discuss this and to engage in a further CFE if necessary.

We also note that the working definition of pre-hedging provided by ESMA at paragraph 6 of the CFE does not make reference to the risk being hedged being uncertain, which is a key component of pre-hedging and distinguishes it from hedging.

<ESMA_QUESTION_PHDG_1>

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

<ESMA_QUESTION_PHDG_2>

No, we do not believe that the proposed definition (taking into account our comments on this definition under Question 1) should encompass other market practices.

<ESMA_QUESTION_PHDG_2>

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

<ESMA_QUESTION_PHDG_3>

We do not agree with ESMA’s statement in paragraph 13 of the CFE that ‘traditional’ hedging will always take place after execution of the client trade, hedging is undertaken once risk is known. This differs from pre-hedging where the risk being hedged is uncertain. This is an important distinction that is not drawn out in the CFE. Therefore we disagree that the fourth column in the table under paragraph 16 will always amount to pre-hedging, in some circumstances (for example where there is certainty on

price) that will be hedging. This serves to further highlight the issue with attempting an exhaustive definition of what amounts to 'pre-hedging'.

Further, it is important to note that in relation to the examples of pre-hedging provided by ESMA in columns two and three, not all liquidity sourced by a provider following the provision of a quote will be in response to the original client RFQ. Certain trades may be normal course market making activity, may be in anticipation of other client transactions or may be for other risk management rather than pre-hedging or inventory management which may occur after the provision of a quote. We additionally note that in relation to column three, this should not occur in practice as firms do not pre-hedge during the last look window, which is in accordance with the GFXC.

<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>

We support the helpful guidance set out in the GFXC on practices relating to last look, and are of the opinion that this is sufficient product specific guidance to mitigate against the potential for any abusive practices relating to 'last look' functionality. We also agree there should not be pre-hedging during the last look window, not just for FX, as per the GFXC, but also for electronic trading.

<ESMA_QUESTION_PHDG_4>

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

<ESMA_QUESTION_PHDG_5>

We are in full agreement and are fully supportive of all of the advantages of pre-hedging set out in paragraphs 24 – 28 of the CFE, and in addition particularly emphasise the benefit that pre-hedging brings in enabling liquidity providers to provide quotes in less liquid markets.

Pre-hedging is an essential activity, which provides significant benefits to clients and the financial markets. Pre-hedging allows for the execution of client orders where they may not otherwise be provided with a price or liquidity and can enable liquidity providers to provide enhanced pricing across a wider range of products than would otherwise be possible, to the benefit of their clients. Pre-hedging additionally allows for a firm to provide a price to a client which should be better, due to the ability of a firm to manage its risk, than the price that the client might otherwise obtain, both due to the firm's own risk management and because pre-hedging is beneficial in terms of lessening market impact on price, particularly for larger orders. For the market, such activity is beneficial because it mitigates the potentially disruptive activity that could result from being limited to trading the whole risk at a single point of execution.

Financial institutions stand ready to provide liquidity and risk-manage transactions for their clients. In several cases, those transactions can be significant in size and/or complexity, thereby warranting delicate handling to ensure orderly execution and delivery of best results to clients. There can be no one size fits all approach to this exercise and it has to be assessed on a case-by-case basis. Factors such as market conditions, firm inventory and client orders are unlikely to be the same on each occasion where pre-hedging is considered therefore experience and expertise is key to properly managing the approach to pre-hedging.

For example, if a client requests a quote to execute a transaction with the firm in an equity derivative, the firm will have to determine its willingness to execute, and its pricing, based on its ability to hedge the position. For the firm to take on the position, it may be important that it is able to source some liquidity in the underlying ahead of the conclusion of the transaction, without alerting the market to the total interest of the client, which the firm concludes will benefit the client. This should deliver for the client significant advantages, both in terms of their ability to execute and the quality of execution, as the hedging activity can be conducted in a way that reduces market impact. Without the ability to pre-hedge a portion of the request, the potential market impact of hedging the request at the point of execution will be included in the calculation of the risk price advanced to clients. It would be extremely challenging for institutions to manage such executions and/or price favourably without the ability to conduct pre-hedging activities in appropriate circumstances.

Similarly, the continuous sourcing of liquidity in pre-hedging situations is beneficial to the financial markets at large as markets are less impacted by potential volatility spikes triggered by significant transactions being brought to the market. For these reasons, we strongly disagree with paragraphs 18 to 23 of the CFE that pre-hedging may not be beneficial for the client or the integrity of the market, as any market abuse risks can be effectively managed. Pre-hedging is a well-established and understood market practice and overall, as a practice, pre-hedging is beneficial for clients and operation of orderly markets. We agree that there may be a risk of disadvantage for the client as a consequence of pre-hedging, as set out in the CFE, however on the occasion that this occurs it generally arises through market movements rather than through inappropriate conduct, and this risk is disclosed to clients, in accordance with accepted market practice, and understood by clients in the context of the benefits pre-hedging offers.

Further, we do not agree as suggested by paragraph 21 of the CFE that there is no clear risk management rationale for pre-hedging in liquid markets. This is because the need of a firm to manage its risk is not solely dependent on the liquidity of a market. Further, the liquidity of a market is not static or as binary as liquid / non-liquid, and can change quickly intra-day or with the introduction of large orders or a large volume of orders, therefore we do not think that it is helpful to separate out pre-hedging by 'market type'. Pre-hedging is legitimate in liquid and non-liquid markets where there is a risk management rationale.

<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>

As a general point, we disagree that RFQs will routinely be considered inside information and an assessment is required on a case-by-case basis in accordance with existing MAR obligations. It is important to note that RFQs are distinct from pending client orders which are dealt with under article 7.1(d) of MAR and which does not capture an RFQ within the given examples of inside information. Further, many RFQs are sent by clients engaging in a price discovery process and are never acted upon.

If, when MAR was first being introduced, there had been a proposal to include RFQs as routinely being considered to be inside information within the scope of examples set out in article 7 this would have resulted in significant industry pushback and we do not think that it is appropriate to attempt to arrive at the same place via this CFE. If a conclusion were to be reached that RFQs were routinely considered inside information this would represent a huge shift in position for the industry and would result in significant market disruption including poor outcomes for clients in terms of price and their execution options. It is important to note that RFQs are largely unsolicited by liquidity providers and if RFQs were routinely considered to be inside information, liquidity providers may, in accordance with MAR, be unable to trade once an RFQ was received which would be a far-reaching and unintended consequence of RFQs being routinely considered to be inside information. This would lead to liquidity being removed from the market, a further poor outcome for clients.

A comprehensive definition of what amounts to inside information, and what is 'foreseeable', is already set out in MAR and market participants are already under an obligation to assess whether information they receive is inside information. Therefore, additional guidance on whether an RFQ can amount to inside information is unnecessary.

<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>

As a general point, we disagree that RFMs will routinely be considered inside information and an assessment is required on a case-by-case basis in accordance with existing MAR obligations. It is also important to note that RFMs are distinct from RFQs, as there is even less certainty about the client's trading intentions.

We agree that if a liquidity provider has precise information which is not public, is price sensitive, and relates to a MAR instrument, then this information is inside information. As set out in our response to Question 6 above, whether this is the case or not cannot be generalised, and must be approached on a

case-by-case basis. Firms are alive to their existing MAR obligations and we do not believe that guidance is required on this point in order to be able to comply.

Even if the liquidity provider does discover the trading intentions of the RFM sender, all of the circumstances would need to be taken into account in determining whether this amounts to “precise information” under MAR, and these situations are rarely straightforward.

We do not agree that in the context of an RFM, when the liquidity provider could discover the trading intentions of the sender, this should be considered as precise. While a liquidity provider may be able to make an educated guess as to the RFM sender’s trading intentions based on an existing commercial relationship, there is unlikely to be sufficient certainty as to the direction of the trade in order for the liquidity provider to act with any degree of precision, and this would not amount to the liquidity provider ‘discovering’ the trading intentions. The liquidity provider would not know with the requisite degree of certainty key components of the order when the RFM is submitted, for example the size of the order if it were made, the direction of the order, the price at execution or whether the trade will happen at all.

Therefore, RFMs cannot as a matter of course be considered precise information and a case-by-case assessment is required in accordance with existing MAR obligations.

<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>

Whilst the size of the RFQ is a relevant factor when looking at the likelihood of the impact on price of the financial instrument concerned it should not be considered the most important or the determinative factor. There are many factors, including but not limited to, the type of instrument, its liquidity profile, the size of the transaction and any recent market news that may also have an impact on the price of a financial instrument, and the relative importance of these factors will vary from day to day, and sometimes intraday.

In our view, the creation of an exhaustive list by ESMA of assessment criteria for RFQs that could potentially have a significant impact on price would be problematic and would not recognize the dynamic and disparate nature of different types of instruments, instructions and markets. Any list would need to be tailored to each type of market, instruction and instrument. From a practical perspective, this would be extremely complex and unnecessary. MAR already places an obligation on market participants to make such an assessment on a case-by-case basis.

We also note that, whilst they provide helpful guidance, the FINRA rule on block trades and FMSB Standards on large trades in FICC markets are not directly comparable when considering RFQs generally as they providing a framework for block / large trades only, rather than pre-hedging generally.

<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>

We agree that pre-hedging would not be carried out when a firm is acting as agent.

We also agree that the GFXC provides a helpful starting point but note that it is FX specific and therefore does not purport to describe all possible cases of risk management rationale for non-FX markets, whereas the FICC Standards on large trades in FICC markets are more informative in providing further examples of risk management rationale. Further, we do not think that it is constructive to attempt to capture all possible cases of risk management rationale that could justify legitimate pre-hedging. Markets and circumstances are constantly evolving and providing a justification for pre-hedging should rest with liquidity providers to assess on a case-by-case basis.

Together with the GFXC, the FMSB Standards on large trades in FICC markets also provide examples of risk management rationale for pre-hedging, as does the Global Precious Metals Code. Therefore, given the GFXC and the FMSB Standards for the execution of large trades, which we support compliance with, we do not think it is necessary to provide further guidance. However, should other industry bodies consider introducing guidance for other markets, we would welcome the opportunity to engage in discussions and further consultation with them.

<ESMA_QUESTION_PHDG_9>

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

<ESMA_QUESTION_PHDG_10>

In our view, pre-hedging practices are not carried out without a risk management rationale; therefore there are no practical examples to provide. This is consistent with the GFXC on pre-hedging and with current market practice in non-FX markets.

In terms of practical examples of pre-hedging with a risk management rationale, these are very case and fact specific and will differ from market to market.

<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, we do not think that pre-hedging be considered legitimate when the market participant is aware with certainty that it will not be awarded the transaction, as in that case, there would not be any risk to manage. We note however that the circumstances which indicate this will differ from transaction to transaction and providing an exhaustive list is problematic.

<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>

The choice of which financial instruments to use to pre-hedge is made on a case-by-case basis by the liquidity provider taking into account all of the relevant circumstances. Pre-hedging may involve the same instruments as are the subject of an RFQ, derivatives of these instrument or different instruments entirely.

Therefore, all financial instruments may be used to pre-hedge and we do not consider that prima facie any should be excluded from pre-hedging activities.

<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>

In relation to obtaining express client consent to pre-hedge the practice necessarily varies between markets, as ESMA notes in paragraph 43 of the CFE. We suggest that adequate client disclosure (as determined by the liquidity provider) should be considered as an indicator of legitimate pre-hedging; however the absence of disclosure should not give rise to a presumption of illegitimacy and we note that in practice, the obtaining of consent does not prevent any illegitimate behaviour from occurring.

In relation to the three cases identified by ESMA in paragraph 39 of the CFE, we agree that in relation to (1), where the liquidity provider pursues only its own interest, this would not amount to legitimate pre-hedging. We also agree that in relation to (2), where the transaction is in the sole interest of the client, this would be legitimate pre-hedging. In relation to (3), where the transaction is in the interest of both the client and the liquidity provider, this would, in our view, be legitimate pre-hedging given that risk management is in the interest of the liquidity provider and is a legitimate reason for pre-hedging. If ESMA is referring to the 'financial' interests of the client and liquidity provider, we do not agree that this should be an indicator. It may be the case that pre-hedging results in improved risk management for the liquidity provider, however by definition this is very difficult to quantify as the opportunity cost of not pre-hedging (noting that a liquidity provider might not be prepared to trade at all without the ability to pre-hedge) cannot be determined. Any outcome will also vary when considering the individual instruments used to pre-hedge on an order by order basis versus the firm's risk management book as a whole and it would not be possible to ascertain any gain at the point at which pre-hedging is carried out, which is when the assessment of legitimacy should be made, rather than retrospectively.

<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>

Whether express consent can be obtained on a case-by-case basis is highly case specific and cannot be generalised for one type of market, such as electronic or a competitive RFQ. Market participants currently provide adequate disclosure to clients in relation to their pre-hedging activities, which is considered market practice.

Where client consent is obtained, we agree that this can ground a presumption of legitimacy of the liquidity provider's behaviour, but note that in practice consent does not prevent any illegitimate behaviour from occurring. Obtaining consent does not turn illegitimate activity into legitimate activity and for that reason there should not be an express requirement for consent to pre-hedging to be obtained.

<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>

We believe that using information in order to trade for the liquidity provider's advantage when the liquidity provider does not intend to execute or knows they cannot execute the transaction with the client would be illegitimate, as would unnecessarily passing on information about the client's intentions to third parties. This would include, for example: a liquidity provider trading in response to an RFQ without intending to provide a quote and trading in manner that is disproportionate to the size of the RFQ. None of these practices would be legitimate behaviour and would not amount to pre-hedging in any event.

<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>

In our view, it would not be feasible for liquidity providers to provide contemporaneous evidence of these four items. However, it may be possible to collect and provide such evidence after the fact on an ad hoc basis if necessary. We do not think, however, that a record keeping requirement would be appropriate in the context of pre-hedging where firms have existing record keeping obligations under MAR and MiFID where applicable.

In order to ensure that any potential risks arising from pre-hedging activities are properly managed, firms must ensure that appropriate systems and controls are in place regarding pre-hedging activities in order to ensure that the pre-hedging activity is carried out in the best interests of clients. These are not new requirements but arise out of the obligations placed on firms by MiFID and MAR. It is therefore unnecessary to impose additional, prescriptive evidential burdens on firms specifically in relation to their pre-hedging activities, when there is an existing regulatory framework which covers these activities appropriately.

Further, we note that where there is existing industry guidance on undertaking pre-hedging which provides market participants with the necessary flexibility to undertake transactions. For example, Principle 11 of the GFC sets out that pre-hedging must be undertaken fairly and with transparency, and how this is achieved is rightly left to market participants. Such a principles based approach is appropriate in order to cater for the dynamic and disparate nature of the financial markets and to deliver good client outcomes.

<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>

No, we do not believe that the liquidity of a financial instrument should be considered as an indicator in determining whether pre-hedging may be illegitimate behaviour. Pre-hedging is just as legitimate a practice in liquid markets as in illiquid ones, with liquidity providers still needing to manage risks by pre-hedging. If pre-hedging were not permitted in liquid markets this would be a significant departure from current market practice and would have a detrimental impact on the ability of firms to effectively manage risk and consequently on the prices offered to clients. As stated in our response to Question 5, the need of a firm to manage its risk is not solely dependent on the liquidity of a market, which is not static or as binary as liquid / non-liquid, and can change quickly intra-day or with the introduction of

large orders or a large volume of orders. Therefore we do not believe that liquidity, instruments or markers should be considered as an indicator in determining whether pre-hedging may be illegitimate behaviour.

As stated previously, we do not believe that providing indicators of legitimate or illegitimate behaviour is constructive.

<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>

We commonly see pre-hedging taking place in relation to transactions with professional clients, as well as with eligible counterparties (ECPs), therefore we do not agree with ESMA’s statement at paragraph 50 of the CFE that *“the practice of pre-hedging primarily ... takes place in what is described as the ‘wholesale markets’ space, where there are dealings between investment firms and eligible counterparties (ECPs)”*. Pre-hedging of professional client orders is common. We see less pre-hedging in relation to retail client orders on an order by order basis, largely due to the fact that retail client orders are less likely to be of the type which would necessitate a firm to pre-hedge in this way, but it does occur.

<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>

Firms already maintain conflicts of interest policies and procedures which are compliant with their obligations under regimes such as MiFID. These policies and procedures will necessarily consider the potential conflicts of interest arising out of the firm’s trading activities and provide a framework for the mitigation and management of such conflicts.

<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>

There is no universal market practice in relation to the disclosure of pre-hedging to clients. However, market participants do ensure that adequate disclosure of pre-hedging is made.

That pre-hedging may take place may be disclosed in a number of ways, including in terms of business, as part of the on-boarding process, in advance of an RFQ or during the course of a voice trading conversation. It is important that market participants are afforded such flexibility, rather than imposing prescriptive requirements, which would have the effect of impeding and / or slowing down existing trading practices and which would have a detrimental effect on the quality of execution for clients.

<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>

There are instances of clients being offered a choice of quotes, but it is not a practice which would be considered routine market practice. This is largely driven by client preference but only in exceptional circumstances, where certain clients will request two prices and more frequently certain clients will not. It would be extremely problematic, leading to unintended consequences on market activities, for ESMA to recommend to investment firms to provide quotes to clients with and without pre-hedging. Firms would be unable to act in accordance with any such recommendation, where on some occasions firms may be unable, for example, for reasons of risk management, to offer a non-pre-hedged price and in flow markets it would be challenging to make two such prices available given the pace of those markets.

<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>

It is important to note that firms are already subject to extensive reporting and record keeping obligations under existing regulation, such as MiFID and MAR, pursuant to which pre-hedging trades are reported and / or recorded, although not separately identified as pre-hedging trades. A further requirement to record pre-hedging trades on a standalone basis would be disproportionate in terms of cost and time where data on these trades is already available and where such standalone recording would not bring any additional benefits in terms of trade surveillance and monitoring.

<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>

There are no specific issues which we would like to highlight in relation to the obligation to provide clear and not misleading information. We would like to note, however, that the practice which ESMA notes in paragraph 66 of the CFE is likely to amount to market abuse under MAR and this may occur regardless of the obligation on an ECP to provide clear and not misleading information, noting that there is an obligation under MAR not to engage in abusive behaviour.

<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>

We agree with ESMA's observations on the definitions and scope of activities of systematic internalisers and OTFs, however we made no comment on the way in which systematic internalisers and OTFs may engage in pre-hedging.

We do not believe that being a systematic internaliser or an OTF impacts the legitimacy of pre-hedging under MAR, where the regulatory status of the liquidity provider is not relevant, and where the same considerations in relation to pre-hedging apply to all types of liquidity provider. If there is a MiFID overlay to these activities, it is up to each firm to comply with applicable MiFID requirements and this is outside the scope of this CFE.

We also note that at paragraph 71 of the CFE ESMA states that *"In line with that, ESMA understands that pre-hedging takes place by means of transactions that are exceptional by nature and cannot be used to circumvent the requirements stemming from MiFID II."* We assume that where referring to pre-hedging taking place by means of transactions that are exceptional this comment is confined to the earlier described activities of systematic internalisers that are based on *"the criteria under which a systematic internaliser would be functionally similar to a trading venue"*. As such, we assume that ESMA does not intend to refer to the pre-hedging activities of systematic internalisers or liquidity providers more generally, where we would not agree that such transactions are generally *"exceptional by nature"*.

<ESMA_QUESTION_PHDG_24>