Via Electronic Mail

Jean Paul Servais	Dr. Mohamed Farid Saleh	Shigeru Ariizumi	Rodrigo Buenaventura
Chairman	Vice Chairman	Vice Chairman	Secretariat General
IOSCO	IOSCO	IOSCO	IOSCO

GFMA IOSCO PRE-HEDGING CONSULTATION RESPONSE

The GFMA represents the common interests of the world's leading financial and capital market participants, to provide a collective voice on matters that support global capital markets. We advocate on policies to address risks that have no borders, regional market developments that impact global capital markets, and policies that promote efficient cross-border capital flows, benefiting broader global economic growth. The Global Financial Markets Association ("GFMA") brings together three of the world's leading financial trade associations to address the increasingly important global regulatory agenda and to promote coordinated advocacy efforts. The Association for Financial Markets in Europe ("AFME") in London, Brussels and Frankfurt, the Asia Securities Industry & Financial Markets Association ("ASIFMA") in Hong Kong and Singapore, and the Securities Industry and Financial Markets Association ("SIFMA") in New York and Washington are, respectively, the European, Asian and North American members of GFMA.

Pre-hedging is an essential risk management activity, which can provide significant benefits to clients and the financial markets when conducted appropriately. As stated in the Global FX Committee's Commentary on Principle 11 of the FX Global Code, which was endorsed by regulators around the world and published as a standalone whitepaper in July 2021 (herein, the "Pre-hedging Commentary" link): pre-hedging is a risk management tool used to "facilitate effective market-functioning across a range of products. It assists in the provision of point-in-time risk transfer by liquidity providers to liquidity consumers in a non-centralized OTC marketplace, where there is no guarantee of price continuity or liquidity at a specific price, by helping to reduce the risk and market impact of trades that are expected to significantly impact market prices."

Pre-hedging is a tool which is used by dealers with the intention to benefit the client by enhancing liquidity provision, allowing better pricing, and/or facilitating smoother execution. This is both due to the dealer's own risk management and because pre-hedging is beneficial in terms of lessening market impact on price, particularly for larger transactions. For the market, such activity is beneficial because it facilitates the efficient use of liquidity and mitigates the potentially disruptive activity that could result from being limited to trading the whole risk at a single point of execution or the risk to the financial system from dealers storing larger-than-needed inventories of risk. In this regard, pre-hedging has similarities to just-in-time inventory management in manufacturing supply chains.

Pre-hedging is as fundamental to principal market making as the arms'-length nature of the relationship between dealer and counterparty when engaging in risk transfer transactions. In connection with those transactions, information on where parties may deal is shared by both sides.

This sharing of information does not, without more, change the nature of this principal relationship or create a duty of trust and confidence as is found in an agency relationship.

Financial institutions stand ready to provide liquidity and risk-manage transactions for their clients. These transactions can be large in size and/or complexity relative to prevailing market conditions, thereby warranting delicate handling to facilitate orderly execution and with the intention to benefit the client. There can be no one size fits all approach to dealers' management of risk in the principal markets arising from client transactions, and dealers must have discretion to assess the best approach on a case-by-case basis. Factors such as market conditions, firm inventory and risk management, and the dealer's market making for other clients and related hedging are unlikely to be the same on each occasion where pre-hedging is considered. Dealers cannot compare prices being offered by other dealers, unlike their clients who can ask more than one dealer. Therefore, experience and expertise is the key to properly managing the approach to pre-hedging.

For example, if a client requests a quote to execute a principal transaction with a dealer in an interest rate derivative that is large relative to the market or at a time of market volatility, the dealer will have to determine its willingness to execute, and its pricing, based on its ability to source liquidity and risk manage the position. For the dealer to take on the risk of managing and hedging the anticipated position, it may be important that the dealer is able to source some liquidity in the underlier ahead of the execution of the transaction, without alerting the market to the total interest of the client. This pre-hedging is intended to benefit the client, both in terms of the ability of the dealer to execute and the quality of execution, as the pre-hedging activity can be conducted in a way that reduces market impact. Whether the intent to benefit the client manifests in an actual benefit is unknowable at the time of pre-hedging as no one can predict with certainty how markets will react. Without the ability to pre-hedge, there is a risk that the potential market impact of hedging the request at the point of execution will negatively impact the risk price for the client. In our view it would be challenging for institutions to manage such executions and/or price with the intention to benefit clients without the ability to pre-hedge in these conditions.

The practice of pre-hedging by dealers occurs for a wide range of clients engaged in a variety of activities, including not only asset managers and hedge funds taking market views, but also for clients in the real money economy. These clients include corporate and private equity clients engaged in mergers and acquisitions and/or financing activities. Such transactions often contain highly sensitive confidential information. The clients of dealers undertaking the pre-hedging activities discussed in this paper are not retail clients or small commercial entities.

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 when significant risk transfer transactions are spread out over time. Pre-hedging is a well-established and understood market practice and overall, as a practice, pre-hedging is beneficial for clients and the operation of orderly markets.

We do note that, as stated in the Pre-hedging Commentary, "while the intent of any liquidity provider conducting pre-hedging should be to benefit the liquidity consumer in executing an anticipated order, there is no guarantee that it will always result in a trade, or a trade at a price that is beneficial to the liquidity consumer." Market conditions can change rapidly, and this risk is disclosed to clients, in accordance with accepted market practices, and understood by clients in the context of the benefits pre-hedging offers.

We believe that there is a clear risk management rationale for pre-hedging in liquid and illiquid markets. The need of a firm to manage its risk is not solely dependent on the liquidity of a market.

Factors for pre-hedging other than liquidity include the type of product, terms of the product, market conditions (including market events, market transparency, market volatility and time of execution), time zone/region, and size of the order relative to the market. Further, the liquidity of a market is not static or as binary as liquid / illiquid, 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'.

As we have described above, the decision to pre-hedge and how pre-hedging is undertaken are facts and circumstances specific and vary across market structures, institutions, asset classes, instruments, and the nature of specific transactions. We represent a wide range of markets and institutions, and we therefore understand that each market has its own complexities related to pre-hedging practices. The existing Codes, when implemented into policies and procedures by dealers (as expected by some market regulators, including by specifying expected time periods for alignment whenever such Codes are updated), become binding upon them. The Codes also build upon existing laws and regulations that apply to dealers and have been designed with this flexibility in mind.

Some of the likely impacts should pre-hedging as a practice be discouraged by global regulators include:

- The likely negative impacts to dealer/client operating models, which may include the need for dealers to change from operating as principal to operating as agent with no discretion on how to price/risk manage transactions. Under this model, dealers likely would not be able to accept the same range of client transactions (i.e. transactions that are larger than typical market size, complex transactions, or transactions for which there is limited liquidity or adverse market conditions);

- The likely negative impacts to clients – such as the potential for wider pricing being shown by dealers due to their inability to manage their risk exposure, or the impact on liquidity caused by additional inventory requirements. Also, clients are likely to be impacted as a result of dealers accepting a more limited type of client transactions (per above);

- The likely negative impact to market functioning due to firms' inability to warehouse risk and spread executions over wider transaction windows in periods of limited liquidity or adverse market conditions. This creates the risk of brittle market liquidity, and potential that client transactions cannot be fully serviced.

As a result, we strongly urge IOSCO to take a flexible approach in any guidance it publishes, which should be principles-based, rather than producing prescriptive rules that may not be appropriate across different markets.

Pre-hedging should not be conflated with unlawful practices like front running. In this regard, we note that the underlying actions described in the misconduct cases and external publications discussed and cited in the report are not permitted for participants adhering to the Codes and standards we cite in our response. Moreover, as the cited misconduct cases themselves illustrate, the underlying actions involved additional circumstances and issues already proscribed by existing laws and regulations in the relevant jurisdictions.

For example, in the recent Federal Court of Australia decision (relating to conduct that pre-dated the relevant Code), the facts as agreed by the parties were that the dealer disregarded an agreed instruction from its client not to pre-hedge (see para 59 of Statement of Agreed Facts - link). The dealer's conduct in this case was directly in violation of contract in a manner intended to disadvantage the client and clearly impermissible under existing Codes/standards and the existing laws and regulations in Australia.

Below we provide detailed responses to IOSCO's questions regarding pre-hedging.

Definition

1. Do you agree that this is the correct definition of pre-hedging? If not, how would you define pre-hedging? Does the definition of pre-hedging clearly differentiate it from inventory management and hedging?

   We do not agree that this is the correct definition of pre-hedging. We make three observations on the definition:

   1. *IOSCO's definition includes unnecessary reference to other "applicable laws and rules." While the referenced laws and rules are important (in that firms must always comply with applicable law and rules) it is not necessary for them to be included in the definition of pre-hedging. It is important that the definition clearly describes only the activity being undertaken. Including unnecessary references to other applicable laws and rules could create confusion and/or ambiguity. We do, however, believe it appropriate for IOSCO to include a separate statement subjecting any recommendations it ultimately makes regarding pre-hedging to compliance with applicable law.*

   2. *The definition should refer to the fact that to fall within the definition of pre-hedging, trading must be with the intention to benefit the client and executed in a manner that is not meant to disadvantage the client or disrupt the market, in order to facilitate the trade that the client may want to undertake.*

   3. *The IOSCO definition should contemplate that more than one transaction might be being undertaken and subject to pre-hedging, such that it is consistent with industry practice, whereby dealers may manage risk on a portfolio basis.*

   In light of the above, the IOSCO definition should be amended as follows.

   "Trading[25] undertaken by a dealer where:

   (i) the dealer is dealing on its own account in a principal capacity;

   (ii) the trades are executed after the receipt of information about an anticipated client transaction(s)[26] and before the client (or an intermediary on the client's behalf) has agreed on the terms of the transaction(s) and/or irrevocably accepted an executable quote(s); and

   (iii) the trades are executed (a) with the intention to benefit the client and (b) to manage the risk related to the anticipated client transaction(s)."

   [25] "Trading" in this context would not cover borrowing, lending, clearing, or correction of trading errors.

[26] Where the transaction has been agreed but the execution would take place at a later point in time; trading to cover the risk of the client transaction should be considered as "hedging" not pre-hedging.

Firms in jurisdictions around the world already have in place policies, procedures and controls that define pre-hedging and govern the way in which it is conducted. It is important that IOSCO does not adopt a definition which inadvertently departs from this existing approach in a way that would cause unnecessary costs in order to unnecessarily realign existing policies, procedures, and control frameworks impacting multiple risk domains. See our answer to Question 25.

IOSCO should provide more detail to illustrate what information received from the counterparty would be viewed as providing information on an "anticipated counterparty transaction" where pre-hedging rules would apply. For instance, pre-hedging rules should not apply in respect of a two-way RFQ or where the dealer does not have certain details such as name, direction (buy/sell), or size.

IOSCO should clarify that hedging following a counterparty order but before a fixing is published is not "pre-hedging" If a counterparty has agreed to a trade, but the price is dependent on a benchmark that is to be published (e.g. GVWAP, GMOC) or the dealer's hedging activities (e.g. stock price purchased as a hedge as the price reference for an OTC derivative), these activities are regular hedging and should not be considered pre-hedging.

Genuine Risk Management Purpose

2. Do you agree with the proposed types of genuine risk management? Are there other factors not mentioned in this report that should be considered for determining genuine risk management?

   We believe that the types of risk management identified by IOSCO are relevant in the context of pre-hedging. However, we do not think that it is necessary or constructive to attempt to capture all possible cases of risk management rationale that could justify legitimate pre-hedging, given the range of markets involved, and the extent to which they are constantly evolving. The rationale to pre-hedge should rest with dealers and be assessed on a case-by-case basis. In addition, we do not consider the use of the word "genuine" to be helpful here, as either there is a risk to manage or there is not, and if there is then the use of the word "genuine" suggests there may be ungenuine risk management.

   Additionally, we would highlight the contribution of client actions and dissemination of information about potential upcoming transactions in influencing how dealers form a realistic expectation of winning resulting transactions. As cited in the FMSB Pre-hedging Case Studies: "There may be greater risk of both information leakage and price slippage when a buy-side participant requests quotes from more [liquidity providers] as more market participants are privy to the information."

   We also believe that a further factor not mentioned in the report is the variety of order types involved. In this respect, please see the Pre-hedging Commentary, section 1, including the description of the interaction between pre-hedging and hedging for RFQ flow.

Available Liquidity

3. Do you agree that pre-hedging of wholesale transactions should be acceptable where there is sufficient liquidity in the underlying instrument/s to hedge after the trade is agreed to? Please elaborate.

   Yes, we agree. We do not believe that the liquidity of a financial instrument should be considered the sole indicator in determining whether or not pre-hedging is, or is not, acceptable. Pre-hedging is just as legitimate a practice in liquid markets as in illiquid ones, with dealers still needing to manage risks by pre-hedging. Considerations such as size of the order relative to the market, the size of the dealer, the nature and conventions of the market, market events and market volatility also determine whether a liquidity provider should pre-hedge in order to minimize market impact and reduce the risk of information leakage.

   As discussed in our pre-amble, liquidity is not static or as binary as liquid/not-liquid, and can change quickly intra-day with market events or with the introduction of large orders or a large volume of orders. Additionally, observable liquidity is not necessarily tradable. It is possible that when dealers try to access observed liquidity, they cannot trade on it. As such, it is difficult to establish objective criteria regarding what constitutes a "liquid" market and to accurately assess the degree of liquidity in a given market at any given time.

4. Can there be a genuine need to pre-hedge small trade sizes in liquid markets for risk management purposes?

   Yes, this should be left to the discretion of the dealer. In a principal market, a dealer may be handling multiple requests and orders of different sizes, and dealers operate across a wide variety of markets. Markets may also be volatile in a way that affects the ability of dealers to execute orders that are small in comparison to other orders in markets that are, at that time, less volatile. A dealer may seek to pre-hedge in these situations such that they can provide the best outcome for their clients based on these factors.

Proportionality of Pre-hedging

5. Where a dealer holds inventory should they first consider using such inventory to offset any risk connected with an anticipated client transaction or should they be allowed to pre-hedge?

   No, a dealer that holds inventory should not be required first to consider using such inventory to offset any risk. Where a dealer holds inventory in principal markets, that inventory may be held for its other market making activities for other clients or as hedges to that market making activity. The fact that a dealer may subsequently be considering entering into pre-hedging transactions is irrelevant to the prior rationale for holding that inventory. It is possible that a dealer might choose to access existing inventory, given the market making and related hedging activities it is undertaking for a broad range of clients. Among other possibilities, there is the possibility that a dealer may be asked to execute additional near-term transactions, which is also likely to be a consideration for dealers in this scenario. There could be multiple client orders in respect of the same inventory, and a better price might be possible if pre-hedging takes place. Additionally, firms may have different trading book structures and positions for different desks and purposes, which makes mandating the use of inventory problematic across firms, jurisdictions, and desks.

6. What factors should dealers consider in determining the size of pre-hedging an anticipated client transaction (e.g., size, instrument type, quotation environment)? Should there be an upper limit for the pre-hedging amount? If so, what type of limits (e.g., percentage based, Greek based) are

appropriate for consideration? Please elaborate your response in relation to bilateral OTC transactions and for competitive RFQ systems including those in electronic platforms.

As stated in the Pre-hedging Commentary, as cited in footnote 27 of the IOSCO Consultation, pre-hedging should be "commensurate with the potential risk assumed by the liquidity provider from the anticipated order and the prevailing liquidity and market conditions." Such factors include whether the potential transaction is 1) large relative to observable market liquidity in the product; and 2) requested during an illiquid time of day or when conditions are illiquid. The FMSB sets out further considerations in its case studies on pre-hedging, including for competitive RFQs, such as the number of liquidity providers in competition (where known by the liquidity provider). However, we do not believe that there should be artificial limits given the wide variety of circumstances that might exist, and markets involved. Provided that pre-hedging is being undertaken with the intention to benefit the client, and in order to facilitate the trade that the client may want to undertake, and the pre-hedging is appropriate in that context, no specific limits on size ought to be provided. Dealers should consider the market impact of their pre-hedging activity, and the size should take into account the size of the risk that may be traded.

Further, from a practical perspective we note that it is not always possible for the dealer to know how likely they are to win the trade, and this has a practical impact on how any cap on pre-hedging activity could be implemented. The dealer needs to be able to make sensible judgments about the size of the pre-hedging they should undertake, and not have to calculate a cap based on incomplete information. For instance, we note from experience that there are also situations when the dealer does not know how many other firms they are in competition with on a trade or when the number has been inaccurately communicated, which would need to be factored into any requirement on setting an upper limit.

Additionally, a cap would impact upon the ability of dealers to test liquidity, which is an important element of pre-hedging (see also answer 3 above).

Client Benefit

7. Do you agree with the concept of client benefit described above?

Yes. Pre-hedging should be conducted with the intention to benefit the client. It is also important to note that (i) there is no guarantee it will always result in the best possible outcome for each client; and (ii) the benefit to the client can take many forms and is not limited to spread- or revenue-based measures. As IOSCO acknowledges, the benefit may be to overall liquidity provision, trade size, execution quality, or market impact.

We believe that pre-hedging can deliver significant benefits to clients, which includes allowing for the execution of client orders which may not otherwise be executable, or executable with a price or liquidity that the dealer is able to provide when they can pre-hedge. Whilst this does not guarantee that pre-hedging will result in a price improvement in each individual transaction, the intention is to benefit client outcomes overall. As stated in our preamble, we agree with the Pre-hedging Commentary which states "while the intent of any liquidity provider conducting pre-hedging should *be to benefit the liquidity consumer in executing an anticipated order, there is no guarantee that it will always result in a trade, or a trade at a price beneficial to the liquidity consumer."*

Pre-hedging serves as a prudent risk management tool for dealers and has a role in maintaining market integrity by spreading risk, particularly the risk associated with large trades, over a time horizon. Liquidity providers may also pre-hedge to reduce the potential impact on the market of executing the potential client request. This risk management is also undertaken with the intention of benefiting the client but, as noted above, this benefit may be broader than just spread- or revenue-based measures. Moreover, the overall outcome for an individual client may be impacted by a range of factors, including potential adverse impacts from the client's own actions. For example, information leakage from a client engaging with multiple dealers or markets (e.g. through RFQ submissions) could negatively impact the price ultimately available to such client.

8. Do you believe that financial benefits derived from pre-hedging by the dealer should be shared with the client? What proportion of the benefit to be shared with the client would be fair? Please elaborate.

No. The concept of a "financial benefit deriving from pre-hedging" is misconceived. Pre-hedging is undertaken with the intention to benefit the client, and to mitigate potential market impact of the relevant transactions in managing the risks to the dealer due to client transactions.

Financial benefits derived from pre-hedging are reflected in a) the ability to provide a price to the client in the first instance, and b) the price quoted to the client. Given the multitude of transactions that take place at any given point in time, it will not be possible or appropriate to attribute price movements solely to pre-hedging and estimate benefits per transaction or otherwise. Similarly, liquidity providers who pre-hedge but are not selected by the client can potentially experience an economic loss – there would be no expectation to share such losses with clients.

Additionally, we are strongly in favour of client choice. Trades are entered into between a dealer and client on a principal (rather than agency) basis and clients at all times have the ability to choose which liquidity providers they interact with in a competitive marketplace and to raise execution outcomes for discussion with any specific liquidity provider. If, on a trade-by-trade basis, a client seeks to obtain executable quotations without a dealer pre-hedging, a client may communicate that instruction to the dealer before it communicates a trade request to the dealer.

However, if a client does not communicate an instruction to refrain from pre-hedging a particular transaction, a dealer may engage in pre-hedging activity consistent with its disclosures provided such activity is done in a manner intended to benefit the client and without an intent to disrupt the market.

As mentioned above, the liquidity provider bears the risk arising from their principal dealing activities, and may realise an economic loss. We note that Question 8 is focused on passing on benefits to the client, but conversely note that there is no consideration of whether losses should be passed onto the client. Similarly, if the anticipated transaction does not materialise, none of the costs of unwinding pre-hedging is passed to counterparties.

While in certain cases the benefit may take the form of considering the pre-hedging activity relative to the potential executable quote on the full notional amount of the trade request, we note that other relevant concurrent factors make it impossible to formulaically reduce any particular pre-hedging activity to a "derived financial benefit." Such concurrent factors include, without limitation, market movements in the underlier, time of day relative to typical or expected liquid/non-liquid periods for *that underlier, amount pre-hedged relative to the full notional amount of the trade request, a possibility that the client may ultimately decline to transact, or other order flow at the same time, as well as other factors.*

9. Should pre-hedging always be intended to achieve a positive benefit for the client or is it enough that a dealer pre-hedges for its own risk management and does not detrimentally affect the client?

   Yes, pre-hedging should be undertaken with the intention to benefit the client (see answer 7). While pre-hedging may be used for dealer risk management, such risk management should ultimately be intended to benefit the client.

Market Impact and market integrity

10. Should dealers be able to demonstrate the actions they took to minimise the market impact of their pre-hedging trading? In the event of not entering the anticipated client transaction, are there any considerations for dealers to minimise market impact and maintain market integrity prior to unwinding any pre-hedging position?

    Pre-hedging should be undertaken in a way that takes into account the risks that the transactions will have an undue market impact. Consistent with the FMSB case-studies, liquidity providers consider the benefit to the client's overall execution outcome when pre-hedging. This means considering both if pre-hedging enables the dealer to charge reduced spreads as well as any potential adverse impact pre-hedging activity may have on the execution price. However, due to the nature of the relevant markets, it is not possible for dealers reliably and accurately to demonstrate on a trade-by-trade basis the outcome of their actions or determine the impact (or lack thereof) on the market of their pre-hedging activity. Depending on the relevant market, at any given point in time there are potentially a number of dealers acting in the market – and it may not be possible to determine the exact impact arising from a specific transaction. In addition, in a principal market, liquidity providers are not only pre-hedging for a potential client order, but also executing transactions with other clients and related hedging. This activity contains highly confidential information of these other clients and the liquidity provider.

    As with any transaction, dealers need to consider market impact and market integrity when unwinding any pre-hedging position. We do not think that specific guidance is necessary for dealers unwinding pre-hedging positions compared to dealers unwinding a position that has been established for any other reason.

    Pre-hedging must be undertaken in accordance with applicable law and rules, including those designed to maintain market integrity. Dealers will have existing policies, procedures, and controls designed to comply with applicable laws and rules. The application of such applicable laws and rules to pre-hedging activity will be very fact specific.

Policies and procedures

11. Do you agree with this recommendation on appropriate policies and procedures for pre-hedging? If not, please elaborate.

    We consider that policies and procedures such as those set out in the GFXC's guidance in the FX Global Code, Global Precious Metals Code and the FMSB's Standard on Large Trades are appropriate as it relates to policies and procedures for pre-hedging. We note that many of our members who have committed to such existing industry codes and standards already have policies and procedures broadly governing pre-hedging including, for example, global market manipulation policies, global confidential and material non-public information policies, global front-running conduct policies, and global procedures for financing or M&A linked deal contingent transactions. Adopting those policies and procedures gives regulatory effect to the industry codes, as regulated firms are required by their regulators to follow their own internal procedures, whether they reflect legislative requirements or voluntary codes. New proposals would have a significant impact on existing policies, procedures, and control frameworks. Discretion should be afforded to dealers in terms of what the policies and procedures should cover.

Disclosure

12. What type of disclosure would be most effective for clients? Why?

    We set out first our views on the key points on disclosure generally raised by the group of Questions 12 – 21 below, before addressing specific points where relevant in response to each question.

    There is no single 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.

    Dealers may disclose their pre-hedging practices in a number of ways, including in terms of business, as part of the on-boarding process, or during the course of a voice trading conversation. It is important to keep this flexibility, rather than imposing prescriptive requirements, which could impede existing trading practices, impact dealer/client relationships, and likely be detrimental to the quality of execution for clients.

    We suggest that consent should be on the basis of adequate client disclosure, per the GFXC FX Global Code and the Pre-hedging Commentary and the FMSB Standard. Most dealers disclose their pre-hedging practices on public-facing websites. The FX Global Code in particular provides a public register of dealer 'cover sheets' linking to such disclosures, which are often cross-asset, identifying specifically where such pre-hedging disclosures may be found. In addition, pre-hedging practices can be disclosed in terms of business and as part of the client on-boarding process. Such disclosures may include language on the potential effects of pre-hedging and allow clients to understand the way in which their dealer will approach transactions and to raise any questions in advance. Depending on the facts and circumstances relating to specific transactions, there may be situations where further supplemental disclosures are made, or additional consent sought. We continue to stress that communication between dealer and client is critical.

    Whether express consent should or can be obtained on a case-by-case basis is highly case specific and cannot be generalised across markets, or trading modalities, such as electronic or a competitive RFQ. As such, we discourage the mandating of requirements for trade-by-trade consent to pre-hedging to be obtained.

Upfront disclosure

13. Should upfront disclosure be applicable irrespective of factors such as the size and complexity of the transaction and/or other factors such as level of client sophistication? Are there any key challenges for dealers to providing pre-trade upfront disclosures?

    "Upfront disclosures" are described in the consultation paper as "used commonly by dealers to disclose their pre-hedging practices." As indicated in our response to Question 12, upfront relationship level disclosures (as described in the consultation paper) are provided by many dealers currently to describe their role in the market and key aspects of their pre-hedging practices. Such disclosures are typically made prior to clients transacting with dealers, not for each transaction, and as such are not dependent on or related to specific types of transactions.

    We believe that upfront disclosure can be a useful way for dealers to explain their approach to pre-hedging generally.

    Typically, these upfront relationship-level disclosures are made available by dealers to all counterparties to ensure consistency. To address the point related to "client sophistication" in this question, it is key to note that clients of principal dealers and market makers are typically large institutional and corporate counterparties, rather than retail clients.

    We do not believe that there are specific challenges for dealers to provide upfront relationship-level disclosures.

14. What should be the minimum content of any upfront disclosure? Please differentiate between bilateral OTC transactions, competitive RFQs and pre-hedging in the context of electronic transactions.

    As indicated in our responses to Questions 12 and 13, upfront relationship-level disclosures (as described in the consultation paper) are provided by many dealers currently in line with the requirements set out in FX Global Code, Global PM Code, and FMSB Large Trade Standard.

    Additionally, we do not believe it is helpful to prescribe the minimum content of upfront disclosures, irrespective of transaction type, given the variety of relevant factors involved. Disclosures are aimed at providing sufficient information to inform counterparties about the approach to pre-hedging taken by that dealer.

Trade-by-trade disclosure

15. Should trade-by-trade disclosure be proportional to factors such as the size and complexity of the transaction and/or other factors such as level of client sophistication? What should be the minimum content of trade-by-trade disclosure? Please differentiate between bilateral OTC transactions, competitive RFQs and pre-hedging in the context of electronic transactions, in particular in electronic trading platforms.

    Whether trade-by-trade disclosures, in addition to upfront disclosures (the type contemplated in Question 13), are necessary, and the nature of any such communication with the client about a transaction, depends on a range of factors. These could include, among others, the nature of the transaction, its size relative market conditions, the potential impact of known market events, the *transactions' complexity, the frequency with which the client undertakes similar transactions, etc. This is the case irrespective of whether the context is competitive RFQs, electronic trading, or any other factors. When and how to make such disclosures should remain at the discretion of the dealer and IOSCO should not attempt to mandate the circumstances in which disclosure is required nor the contents of such disclosure.*

16. Are there any challenges or barriers to trade-by-trade disclosure in the context of competitive RFQs and in the context of electronic trading? If yes, please elaborate.

    Irrespective of factors relating to RFQs and electronic trading, IOSCO should not mandate the circumstances in which disclosure is required (see our response to Question 15 above).

Post-trade disclosure

17. Would clients benefit from post-trade disclosures about the dealer's pre-hedging practices in a transaction?

    We are not supportive of a prescriptive requirement for "post-trade disclosures" which are described in the consultation paper as "where the dealer discloses to its client a summary of how the pre-hedging was executed and the overall client outcome."

    The systematic production of post-trade disclosures on a transaction-by-transaction basis would not only be operationally challenging to implement, and costly and inefficient, but would also not be meaningful given that the counterfactual (i.e., what would have occurred in the absence of pre-hedging) is not observable. As a result of these challenges, the information produced as a result of this analysis is likely to be flawed and would not be appropriate for dealers to share as a representation of the outcomes of their actions.

    Counterparties have the ability currently to request further information from dealers about specific transactions if and when required; however a requirement for post-trade disclosures should not be mandated.

    For the reasons set out in our response to Question 10 above, because of adherence to confidentiality and information handling protocols, it may not be feasible or practicable to offer the client granular details about pre-hedging activities conducted or the impact thereof. However, in the case of a large trade, if requested by a client and consistent with the principal nature of the relationship and with appropriate confidentiality restrictions, liquidity providers could share with the client general information on the pre-hedging approach undertaken by the dealer and general market colour over that period of time. In addition to upfront relationship-level disclosures, a dealer should be willing to engage with a client to answer all reasonable questions regarding the dealer's policies and approach to pre-hedging prior to any trading. A client can always condition its orders on the provision of certain disclosures if it wants to do so. See also our answer to Question 15 above, and our response on supervisory controls in Question 22 below.

18. Should the nature and form of post-trade disclosure be agreed between the client and dealer at the start of their engagement on an anticipated transaction and be proportional to factors such as the size and complexity of the transaction and/or other factors such as level of client sophistication?

    As indicated in our response to Question 17, we are not supportive of a prescriptive requirement for "post-trade disclosures."

Liquidity providers in principal markets are undertaking market making and related hedging activities for multiple counterparties and pre-hedging activity may not be isolated, making ex ante agreement on the nature and form of any post-trade disclosure impractical. Accordingly, market participants could instead engage with dealers on a post-trade basis based on relevant facts and circumstances.

19. Are there any barriers to post-trade disclosure? Please differentiate between bilateral OTC transactions, competitive RFQs and pre-hedging in the context of electronic transactions, in particular in electronic trading platforms.

    As stated in our response to Question 17, we are not supportive of a prescriptive requirement for post-trade disclosures due to the nature of many of the relevant markets and difficulty in reliably isolating the cause of resulting pricing action. Additionally, it is not possible to identify a counterfactual outcome (i.e., what would have happened should the dealer not pre-hedge) to enable comparison. Additionally, it would be impractical to introduce this expectation on RFQs and electronic trading platforms.

Consent

20. Do you agree that clients should have the ability to explicitly inform the dealer that they do not want pre-hedging to take place in relation to a specific transaction (or revoke explicit or implicit consent to pre-hedging)? Are there any circumstances under which the dealer would not be obliged to follow the new client instructions? If not, what are the potential issues or risks to clients of this approach? Please elaborate your response to the question for bilateral OTC transactions, for competitive RFQ systems and for those in electronic trading platforms.

    Many of our members already permit such opt-out in their general disclosures. Dealers are obliged to follow trade-by-trade instructions received by clients. In addition, clients have a number of ways in which they can engage with a dealer, such as asking a dealer to work an order instead of asking for a risk price, if they do not want pre-hedging to take place.

    Clients may "opt out" and request that the dealer not engage in pre-hedging for a particular transaction; however, such request may limit the ability of the dealer to provide transaction execution at a favourable price, if at all.

21. Should dealers be required to obtain explicit prior consent to pre- hedge for certain types of transactions? Please elaborate your response to the question for bilateral OTC transactions, for competitive RFQ systems and for those in electronic trading platforms.

    No. Obtaining explicit consent to pre-hedge is unworkable in many circumstances given the speed at which markets move, and irrespective of the type of transaction involved. Additionally, a client has always had the right to stipulate, when asking for a quote, whether they would prefer pre-hedging not to take place. A dealer would be obliged to honour the client's wishes, not least because the client would decline to trade with the dealer should they refuse.

Post-trade reviews

22. Should stand-alone post-trade reviews be conducted for pre-hedging? How would this improve supervision of pre-hedging activities? Could this review be also used to respond to client requests for post trade review of execution practices?

    Stand-alone post-trade reviews with clients are problematic for the reasons mentioned in the answer below to Question 23. Many of our members, regardless, adhere to the FX Global Code, Global Precious Metals Code, and the FMSB Standard and use a number of procedures and controls that are designed to monitor trade execution and client outcomes, including trade surveillance, communications surveillance, and internal supervisory and risk escalations, as well as periodic reviews of fair pricing and trade execution metrics and/or surveillance by internal fair pricing and best execution committees.

    These procedures and controls are typically implemented through a risk-based approach specific to the business activities and geographic regions. Typically, these risk assessments are reviewed periodically with reference to a number of factors to identify where additional controls may be required.

    In addition, such members have market abuse trade surveillance functions that include front running trade surveillance across products designed to detect instances of attempted or actual front running.

    While some of the materials from internal supervisory reviews could potentially also help with client requests for post-trade reviews, this would be limited as any data pertaining to other counterparties' trading interests would not be shared.

    For these reasons, specific post-trade reviews only aimed at pre-hedged transactions will operationally be difficult to do, and will not prove additive to the existing controls described above.

Controls

23. Do you think it is reasonable (in terms of costs and benefits) to require dealers to have internal controls to ensure differentiation between Pre-Hedging and inventory management?

    As discussed in our response to Question 10, dealers do not cease their principal market making and related hedging activity for other clients when they engage in pre-hedging and this pre-hedging activity may be inextricably linked to such other activity, particularly when a dealer is hedging its risk at a portfolio level. In addition, dealers are already subject to extensive reporting and record keeping obligations under existing regulations, which do not require the identification and recording of pre-hedging trades separately. The creation of a new requirement to do so on a standalone basis would be disproportionate in terms of costs and time where data on such trades is already available, and where such standalone recording would not bring any additional benefits in terms of trades surveillance and monitoring. Dealers undertake pre-hedging with the intention to benefit the client, and bear the risk of such activities, as with other inventory management.

Record-keeping

24. What level of detail would be sufficient to have adequate records of pre-hedging activity to facilitate supervisory oversight, monitoring and surveillance?

    See our response to Question 23 above. Supervisory oversight, monitoring, and surveillance should be risk-based and therefore include a focus on larger trades and higher risk activities.

Industry codes

25. Do you believe that the industry codes already meet some or all of the recommendations? If so, please explain in detail how.

    Yes. Extensive work has been undertaken and co-ordinated guidance now exists in a number of widely-accepted industry standards, which have been developed with participation from across the industry: sell-side, buy-side, and for the Codes, central banks. These set out a constructive and principles-based approach to the key topics set out by IOSCO in its questions. They are kept up to date thanks to periodic reviews, often in conjunction with authorities and central banks. More than 1,300 institutions globally have provided statements of commitment to the FX Global Code, and 190 have signed up to the Global Precious Metals Code. At least 12 central banks are also signatories to the FX Global Code and consider adherence to the FX Global Code in particular a pre-requisite for participation in their FX Committees. When a dealer signs up to such an industry code, and embeds its guidance in its internal policies and procedures, the dealer is then required by their regulators to follow these policies and procedures in the same way as with policies and procedures that derive from legislation. The Codes complement existing laws and regulators' rules. The industry associations represented in this response strongly encourage IOSCO to reflect upon the benefits of the existing industry-led approach and to ensure that any additional measures that may be proposed are aligned with existing practices that have developed as a result.

Sincerely,

Adam Farkas
Chief Executive Officer, GFMA