Pre-hedging

CONSULTATION REPORT

The Board of the
International Organization of Securities Commissions

CR/11/24 November 2024

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Foreword

The Board of the International Organization of Securities Commissions (IOSCO) is seeking comments on this consultation report on pre-hedging.

In line with IOSCO's established approach, the pre-hedging recommendations proposed in this consultation report will be addressed to IOSCO members. The recommendations aim to support jurisdictions seeking to establish acceptable market practices where pre-hedging may be used.

In addition, this consultation report includes information for all interested parties including dealers, issuers, brokers, investors and other wholesale market participants to consider in relation to pre-hedging. The consultation and the proposed recommendations should also promote greater clarity regarding pre-hedging practices.

How to Submit Comments

Comments may be submitted through the following survey: LINK. - on or before 21st February, 2025

All comments received will be made available publicly, unless anonymity is specifically requested. Comments for which anonymity is not sought will be converted to PDF format and posted on the IOSCO website.

Important: All comments will be made available publicly, unless anonymity is specifically requested. Comments will be converted to PDF format and posted on the IOSCO website. Personal identifying information will not be edited from submissions.

If you require technical assistance on completing the survey, please contact: itsupport@iosco.org

If you have questions about the report or the consultation, please contact Alp Eroglu, Senior Policy Advisor (alp@iosco.org) and Flavio Bongiovanni, Policy Advisor (f.bongiovanni@iosco.org).

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Executive Summary

Pre-hedging is used by dealers to manage the risk of anticipated wholesale[1] principal orders in relation to primary market offerings and secondary market transactions. This can occur in securities and derivatives transactions on trading venues and over the counter (OTC) markets, and across a range of asset classes (e.g., equity, fixed income, currencies, and commodities).

For the purposes of this consultation report, IOSCO proposes to define pre-hedging as "*trading undertaken by a dealer, in compliance with applicable laws and rules, including those governing frontrunning, trading on material non-public information/insider dealing, and/or manipulative trading 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 and before the client (or an intermediary on the client's behalf) has agreed on the terms of the transaction and/or irrevocably accepted an executable quote; and*

(iii) *the trades are executed to manage the risk related to the anticipated client transaction.*" [2]

There can be benefits from the use of pre-hedging for dealers and clients to price and execute certain transactions. However, various market participants, standard setters and national and supra-national authorities have raised potential concerns about the appropriateness of pre-hedging practices.

This consultation report assesses potential conduct and market integrity issues associated with the practice of pre-hedging. It considers IOSCO members' existing regulatory approaches to pre-hedging and other international standards and identifies any potential issues and gaps in market standards.

Existing industry codes and standards relating to pre-hedging may apply inconsistently because they target mostly OTC markets and/or only specific asset classes, or do not cover the range of potential issues related to pre-hedging. They are not applied universally and generally not endorsed by regulators and there are no monitoring, oversight, supervision, or enforcement mechanisms to ensure that conduct occurs in line with them.

This report sets out a proposed definition of pre-hedging and a set of proposed recommendations as guidance for regulators to consider in relation

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1 For a definition of "wholesale markets" for the purposes of this Report, see the IOSCO Task Force Report on Wholesale Market Conduct, June 2017, page 4, *"While there is no widely accepted definition, wholesale markets may be understood to be those markets that predominantly consist of professional counterparties where both counterparties are persons or firms that are considered more sophisticated than typical retail customers or participants".*

2 For more details about the definition of pre-hedging, see chapter 5.

to when pre-hedging may be appropriate and the effective management of conduct risk arising from pre-hedging.

IOSCO seeks feedback on the proposed definition, and a minimum set of recommendations as guidance which are broadly applicable in most circumstances. IOSCO additionally seeks feedback on whether the proposed recommendations need to be adapted to specific circumstances. For example, IOSCO particularly requests feedback in relation to the differences in the proposed recommendations between bilateral non-electronic transactions and pre-hedging in the context of electronic trading, including competitive requests for quotes (RFQs).

Following feedback to this consultation report, IOSCO will publish a final set of recommendations. IOSCO members should consider how they wish to apply these recommendations to dealers in their jurisdictions, taking into account their relevant legal and regulatory framework.

The proposed definition and recommendations as guidance in this report seek to build on the work of the European Securities Markets Authority (ESMA),[3] as well as on the existing guidance of the FX Global Code,[4] the Global Precious Metals Code,[5] and Financial Markets Standards Board (FMSB)[6] to facilitate international regulatory alignment through the proposed recommendations.

The report includes some questions on certain aspects of pre-hedging where there may be a divergence of opinion. This consultation process will provide interested parties with the opportunity to provide feedback. Stakeholders can also respond if the industry codes already meet some or all of the recommendations, and if so, how.

IOSCO will consider all consultation responses and anticipates providing a final report with recommendations to IOSCO members in 2025. Once the report is finalized, IOSCO members should then consider how to apply the recommendations in their jurisdictions.

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3 ESMA: Report On the Call for Evidence on pre-hedging: https://www.esma.europa.eu/sites/default/files/2023-07/ESMA70-449-748_Feedback_report_on_pre-hedging.pdf

4 Global Foreign Exchange Committee: Global Code, A set of global principles of good practice in the foreign exchange market: https://www.globalfxc.org/uploads/fx_global.pdf

5 Global Precious Metals Code: https://cdn.lbma.org.uk/downloads/GPMC/Global-Precious-Metals-Code-2022.pdf

6 FMSB: Standard for the execution of Large Trades in FICC markets: https://fmsb.com/wp-content/uploads/2021/05/FMSB_Large_Trades_Standard_-FINAL-05.05.21.pdf

List of Abbreviations

AMF	Autorité des Marchés Financiers (France)
ASIC	Australian Securities and Investments Commission
ESMA	European Securities Markets Authority
FIA EPTA	FIA European Principal Traders Association
FICC	Fixed Income, Currencies and Commodities
FINRA	Financial Industry Regulatory Authority
FMSB	Financial Markets Standards Board
FMSB Spotlight Review	FMSB's *Pre-hedging: case studies* Spotlight Review July 2024
FMSB Standard on Large Trades	FMSB's Standard for the execution of Large Trades in FICC markets
FX	Foreign exchange
FX Global Code	A set of global principles of good practice in the foreign exchange market published by the GFXC
GFMA	Global Financial Markets Association
GFXC	Global Foreign Exchange Committee
Global Precious Metals Code	Standards and best practice expected from market participants in the global OTC wholesale precious metals market, published by the London Bullion Market Association
IOSCO	International Organization of Securities Commissions
IOSCO Committee 3	IOSCO Standing Policy Committee on Regulation of Market Intermediaries
OTC	Over the counter
RFQ	Request for quote
WSP	Written supervisory procedures

Chapter 1. Introduction

In June 2023, the IOSCO Board approved a mandate to assess the observed vulnerabilities in pre-hedging practices by dealers and how such potential vulnerabilities could be mitigated, particularly focusing on disclosure and transparency to clients and market intermediaries.

To achieve this objective, IOSCO considered members' regulatory approaches to pre-hedging and other international standards and guidance to identify the relevant themes and potential gaps.

Scope and approach

In preparing the report, IOSCO submitted a survey to IOSCO members and a separate survey to a select number of industry associations that deal with pre-hedging matters, to gain different perspectives of the practical implications of any potential recommendations.

The surveys focused on issues from a market integrity and client protection perspective, such as whether there are differences in pre-hedging practices based on asset class, size of order, liquidity, or number of dealers. Importantly, IOSCO considered contractual arrangements and practices for disclosure, client consent and reporting to mitigate potential risks related to pre-hedging practices as well as policies and procedures for managing conflicts of interest. Further, the survey sent to IOSCO members sought to understand the regulatory framework in place for pre-hedging activity in their jurisdiction.

Differences emerge in determining the extent of regulatory requirements, particularly with respect to consent mechanisms, percentage limits if applicable, and the need for specific guidance in competitive quoting scenarios.

Considering that jurisdictional regulations and approaches to insider trading, front-running and manipulative trading differ fundamentally between jurisdictions, IOSCO has not analyzed when pre-hedging entails market abuse in different jurisdictions. While these measures are often effective in addressing many of the potential risks highlighted in this report, the proposed recommendations should be read first and foremost as ancillary to each jurisdictions' existing regulations, including market abuse regulations.

IOSCO's focus has been on identifying recommendations that IOSCO members can use to assess as guidance when the practice of pre-hedging may be acceptable from the perspective of market integrity and investor protection and addressing any existing conflicts of interest. IOSCO has also focused on recommending controls that IOSCO members could require from dealers to mitigate any potential conduct risks arising from pre-hedging.

This report assesses the potential market integrity and conduct risks associated with the practice of pre-hedging. The report considers whether these risks are exacerbated by differences in practices and disclosure. It considers IOSCO members' regulatory approaches to pre-hedging, international standards and guidance, and identifies potential issues and gaps for market participants.

Just as a global definition of pre-hedging does not exist, so too does global regulatory guidance on when pre-hedging is acceptable, and the management of conduct risks when it is used. There is also a broader market integrity question relating to information asymmetry and the market impact of large pre-hedged trades.

The report proposes a definition for pre-hedging and sets out proposed recommendations as guidance to IOSCO members for when and how pre-hedging may be acceptable. This is intended to facilitate international regulatory alignment.

Outline of the consultation report

This report considers the results of the IOSCO members and industry surveys in chapters 3 and 4 respectively. Chapter 5 proposes a definition of pre-hedging and provides a schematic of pre-hedging that enables readers to consider the recommendations for when pre-hedging may be acceptable. In chapter 6, the report proposes recommendations for the circumstances in which pre-hedging may be acceptable. Chapter 7 proposes recommendations for the management of potential conduct risk from pre-hedging and seeks comments on what additional controls and circumstances IOSCO members could consider as guidance. In chapter 8, the report sets out additional proposed suggestions for clients to enable them to better manage any potential risks that can arise from pre-hedging.

Next steps and potential future work

IOSCO invites comments on the proposed recommendations and questions in this consultation report. Following the consultation, IOSCO will consider the feedback provided and aim to issue a Final Report in 2025. The Final Report will set out a definition of pre-hedging and recommendations as guidance that IOSCO members should consider implementing in their jurisdictions, with the aim of facilitating international regulatory alignment.

Chapter 2. Background and Context

Clients[7] seek prices from dealers in a range of financial instruments (e.g., equities, fixed income, currencies, and commodities), prior to entering into an irrevocable agreement on a primary market or secondary market deal or accepting an executable quote from a dealer. In doing so, the client passes information to the dealer about the interest to trade, such as the security or securities they wish to trade in, size, direction, price range, speed of execution, and other factors.

Some dealers use this information about an anticipated transaction with a client as a risk management tool to buy or sell related inventory to manage the risk of assuming the position associated with the anticipated transaction. This practice is typically referred to as pre-hedging (or pre-positioning) and is used by dealers to manage their inventory risk.

In traditional hedging, the inventory risk is certain and risk management by the dealer takes place after the client (or a market intermediary on the client's behalf) has an irrevocable agreement on a deal or accepted an executable quote from a dealer. In contrast, in pre-hedging the risk management trading commences prior to the client having an irrevocable agreement on a deal or accepting an executable quote from a dealer.

Pre-hedging may reduce market risk for dealers and the market impact of trading by lengthening the hedging window, which can allow better pricing for clients. However, these benefits may come with increased risks, due to the potential conflicts of interest the practice may pose from an investor protection and market integrity perspective.

There are a broad range of pre-hedging practices which may give rise to potential conduct risks including:

- ***Misuse of information:*** There is a risk that a dealer will misuse the information about an anticipated transaction for its own benefit at the expense of the client, for example, to reduce a potential risk exposure it is holding without a clear intent to trade with the client, or to lock-in additional margin at the expense of the client.
- ***Lack of transparency:*** Pre-hedging practices may not be transparent or visible to the client and others in the market. In those cases, it may be difficult to monitor and assess whether pre-hedging is providing the purported benefits (especially to clients) and whether dealers are causing potential disadvantage or harm in their execution of the client's anticipated transaction.

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[7] Please note that a client of a dealer, including when it is a direct participant in a trading platform is considered as a counterparty in certain jurisdictions.

- ***Lack of client consent and understanding:*** Clients may be unaware of a dealer's intention to pre-hedge or of the potential market impact from the trading. They may also be unaware that a dealer's intention to pre-hedge can influence the quote they receive from the dealer. This is because the market impact costs for the dealer may be lower if they pre-hedge compared to hedging after the client has agreed to an irrevocable agreement on a deal or accepted an executable quote from the dealer.

Globally consistent and coordinated approach

Currently, there is no global regulatory guidance on pre-hedging. As such there are differences in pre-hedging practices and how conduct risks arising from such practices are managed.

In chapter 3 of this report, the responses to the survey of IOSCO Committee 3 members indicate few of the surveyed IOSCO members have regulations in place that specifically target pre-hedging or are in the process of introducing specific regulation. In chapter 4, responses to the survey of certain industry associations indicate that despite the development of industry codes and standards on pre-hedging in certain limited areas, some industry respondents believe there remains some uncertainty for dealers, particularly when they are active across multiple jurisdictions or asset classes that may or may not take industry codes and standards into account.

Some IOSCO members believe that the lack of a globally agreed definition, the absence of global regulatory guidance and potential uncertainty for dealers may possibly undermine competitive neutrality and efforts to improve outcomes for clients through pre-hedging.

For the purposes of this consultation report, IOSCO proposes to define pre-hedging as "*trading undertaken by a dealer, in compliance with applicable laws and rules, including those governing frontrunning, trading on material non-public information/insider dealing, and/or manipulative trading: 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 and before the client (or an intermediary on the client's behalf) has agreed on the terms of the transaction*[8] *and/or irrevocably accepted an executable quote; and*

(iii) *the trades are executed to manage the risk related to the anticipated client transaction.*" [9]

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[8] 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 possible anticipated client transaction should be considered as "hedging", not pre-hedging.

[9] For more details about the definition of pre-hedging, see chapter 5.

This consultation report aims to propose recommendations and seeks comments on how to best facilitate international regulatory alignment and a consistent regulatory environment for pre-hedging that was raised by certain IOSCO members.

Chapter 3. Jurisdictional Practices & Misconduct Cases

To support the analysis in this report, a survey was sent to the members of IOSCO Committee 3, with 21 responses received (see Appendix A). The questions posed to IOSCO members covered a range of topics, seeking to understand the practice of pre-hedging and the related risks and mitigants they have seen in their jurisdictions.

The responses revealed a broad range of perspectives, showing areas of agreement and divergence among IOSCO members.

Pre-hedging may be an acceptable tool when undertaken appropriately. However, it may require a thorough evaluation about the extent of the regulatory requirements, particularly with respect to potential conflicts of interest, consent mechanisms, disclosure, percentage limits for pre-hedging and the need for specific guidance in competitive RFQ scenarios.

A common thread running through the responses was the recognition of pre-hedging as a risk management tool for larger transactions, with an emphasis on its potential benefits, for example, for dealers in managing order flow and reducing market impact and for improving client outcomes in terms of liquidity and price.

There was general agreement from IOSCO members on the importance of disclosure and consent in ensuring transparency, but opinions differed on whether general consent through terms and conditions is sufficient or whether more explicit, trade-specific consent should be required.

The issue of limits for percentages of pre-hedged transactions also elicited mixed responses. While some IOSCO members advocated for no fixed limits, others expressed their concern about the potential for market manipulation and emphasized market integrity concerns when pre-hedging exceeded the intended transaction size. Consideration of universal limits reflect the nuanced nature of pre-hedging, with regulators considering the differing characteristics of different asset classes and trading environments.

The issue of promoting a level playing field among dealers with respect to pre-hedging practices revealed a range of views. While some IOSCO members argued for tailored guidance to address the unique considerations of pre-hedging in different contexts, such as considering transaction size or trading protocol, others argued against a narrow focus and recommended a holistic approach that allows discretion in differing markets and structures.

Overall, the responses reflect a complex landscape in which IOSCO members seek to strike a balance between the use of pre-hedging to improve risk management and liquidity provision and protecting against poor client outcomes and potential market abuse.

Established rules and regulatory guidance

Few of the surveyed IOSCO members have regulations or regulatory guidance[10] in place that specifically target pre-hedging. Some jurisdictions do have existing regulations that, while not specifically relating to pre-hedging, would include pre-hedging conduct within broader regulations.[11]

To maintain market integrity, most surveyed IOSCO members rely on existing market abuse regulations with a focus on insider dealing, including front running, and market manipulation. In many jurisdictions, information related to client transactions can fall within the legal definition of inside information, which means that dealers could be at risk of violating market abuse regulations, including insider dealing or market manipulation, when pre-hedging.

In July 2023, ESMA[12] published its Final Report on the Call for Evidence on pre-hedging. Given the feedback received and the issues raised, ESMA stated in the report that it agreed with the views expressed by some stakeholders, requesting international coordination among regulators of any future ESMA action on pre-hedging to ensure a level playing field across EU and non-EU jurisdictions.

Misconduct cases

IOSCO members are aware based on suspicious matter reports and some enforcement cases that misconduct may potentially be occurring in connection with pre-hedging practices conducted by certain dealers in different jurisdictions.

The proposed recommendations in this report seek to achieve a common understanding between IOSCO members of what may be acceptable pre-hedging practices and how to manage potential conduct risks to promote a level playing field for dealers to undertake pre-hedging with confidence and facilitate more competitive pricing to clients globally across jurisdictions.

Certain surveyed IOSCO members reported that they regularly receive suspicious trading reports regarding pre-hedging activity. For example, the AMF responded that pre-hedging is one of the issues about which they receive

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10 The Australian regulator, ASIC, set out pre-hedging regulatory guidance in a letter addressed to CEOs in Australia on 1 February 2024: https://asic.gov.au/about-asic/news-centre/news-items/asic-s-guidance-for-market-intermediaries-on-pre-hedging/C

11 See, e.g., FINRA Rule 5270 in the United States: https://www.finra.org/rules-guidance/rulebooks/finra-rules/5270

12 ESMA is an IOSCO associate member

the most suspicious matter reports from dealers, with 64% of these reports relating to pre-hedging in fixed income and FX instruments.[13]

In the US, FINRA has settled matters involving violations of FINRA Rule 5270 (Front Running of Block Transactions). For example, in October 2016, FINRA fined a firm in relation to its conduct and supervisory systems around frontrunning activity. Without admitting or denying the findings, the firm consented to the sanctions and to the entry of findings that after receiving and exposing only a portion of a customer's order to the marketplace, the firm purchased contracts of calls for, and sold shares from, its own proprietary account to hedge its anticipated facilitation of the remainder of the customer order.[14] This conduct constituted a violation of FINRA Rule 5270.

The findings further stated that the firm's supervisory system for reviewing securities transactions was not reasonably designed to ensure compliance with applicable anticipatory hedging and front-running rules, and the firm failed to enforce compliance with its written supervisory procedures (WSPs) applicable to anticipatory hedging and front-running transactions.

Specifically, the firm failed to enforce and supervise enforcement of its WSPs regarding the escalation of anticipatory hedging and front-running issues to the appropriate supervisory and/or compliance personnel. Further, the firm's WSPs did not address - or provide for the supervision of - transactions designed to hedge the partial exposure of customer orders to ensure compliance with applicable anticipatory hedging and front-running rules. This conduct constituted a violation of FINRA Rules 2010 (Standards of Commercial Honor and Principles of Trade) and 3110 (Supervision).

In Australia, a major case involving pre-hedging was settled with the Federal Court of Australia in January 2024 declaring that a firm engaged in unconscionable conduct in October 2016 when executing a $12 billion interest rate swap transaction. The court also declared that the firm failed to have adequate arrangements to manage the conflict of interests between it and the client and did not do all things necessary to ensure that the swap transaction was provided to the client efficiently, honestly and fairly. [15]

The firm was ordered to pay the maximum penalty of AUD $1.8 million in relation to the conduct, together with AUD $8 million for ASIC's litigation and

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[13] Mostly bonds for 49%, CDS for 8% and interest rate swaps for 5% and FX derivatives 3% (out of 64% in total)

[14] In reference with Nomura Securities International, Inc. (2016): https://www.finra.org/sites/default/files/fda_documents/2013038492801_FDA_RB7X2845%20%282019-1563149992370%29.pdf.

[15] 24-011MR Court declares Westpac engaged in unconscionable conduct for interest rate swap, maximum penalty applied: https://asic.gov.au/about-asic/news-centre/find-a-media-release/2024-releases/24-011mr-court-declares-westpac-engaged-in-unconscionable-conduct-for-interest-rate-swap-maximum-penalty-applied/

investigation costs. The court declared the firm's conduct was unconscionable in that:

a) the firm was aware of its client's concern about trading prior to the swap transaction (pre-hedging) that had the potential to adversely affect the price of the swap transaction to their detriment. Every basis point increase to the price of the swap transaction would involve a cost to the client of about AUD $4.7 million.

b) Despite being aware of its client's concerns, the firm acted on an internal plan to pre-hedge up to 50% of the interest rate risk by trading in significant volumes of interest rate derivatives in the market before the swap transaction was executed.

c) the firm failed to obtain client consent or give clear and full disclosure about the extent of its planned pre-hedging; and

d) Once the firm commenced its on-market pre-hedging trading, the client could not protect itself against the risk that the firm's trading would increase the price of the swap transaction to the client.[16]

16 See Ibid 15

Chapter 4. Industry Practices & Standards

Separate to the survey sent to IOSCO members, a survey was sent to a selection of industry associations with members who deal with pre-hedging matters[17] to understand market practice in relation to pre-hedging and to obtain the views of different stakeholders.

During the survey process, IOSCO Committee 3 held industry roundtables in December 2023 and April 2024 with selected industry associations[18] and other stakeholders to obtain their views.

Survey responses

The responses to the questions from these industry associations show that the pre-hedging landscape is complex and subject to varying interpretations.

The industry respondents generally believe that pre-hedging is a long-standing and permissible risk management activity when conducted in accordance with industry standards, such as the FX Global Code, the Global Precious Metals Code and the FMSB Standard on Large Trades. They also believe that these standards provide useful guidance on how to conduct pre-hedging activities in other asset classes and markets. However, one respondent has called for global definitions and standards across markets in line with ESMA's call for evidence on pre-hedging, particularly in the context of RFQs.

The respondents to the industry survey and the roundtables may not represent a complete picture of the market participants' view on pre-hedging. In addition, as the respondents represent stakeholders in different markets, some of the differences in responses may be due to the differences in market conventions

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17 GFMA (representing AFME, ASIFMA and SIFMA), FIA EPTA, and ISDA submitted written responses to IOSCO's industry survey on pre-hedging.

The GFMA brings together three of the world's leading capital markets trade associations. The Association for Financial Markets in Europe (AFME), the Asia Securities Industry & Financial Markets Association (ASIFMA), and the Securities Industry and Financial Markets Association (SIFMA) are, respectively, the European, Asian, and U.S. members of GFMA.

FIA EPTA operates as an affiliated organisation of the Futures Industry Association (FIA). FIA EPTA's members are committed to expanding the range of products and markets where they provide liquidity, resulting in more efficiency and lower costs for end-investors.

ISDA is a trade organization headquartered in New York and comprises of participants in the market for over-the-counter derivatives globally.

18 GFMA, FMSB and FIA EPTA attended the C3 meeting in December 2023. AFMA and ISDA attended the C3 meeting in April 2024.

The FMSB is a private, member-led organisation with participation from a broad cross-section of financial market participants globally.

AFMA is the leading finance industry association in Australia promoting efficiency, integrity, and professionalism in Australia's financial markets.

and the presence or absence of pre-hedging guidelines. Each perspective contributes to the broader conversation about shaping policies, regulations and industry best practices for greater international alignment, effective risk management and fair market conduct.

Key themes raised from the responses have been grouped and explained below:

Principal* vs *agency

There is a strong consensus from industry respondents that pre-hedging may only take place when the dealer acts as principal (i.e., not when acting as agent). This is consistent with existing industry standards and principles, including the FMSB's Standard on Large Trades (Core Principle 2), the FX Global Code (Principle 11), and the Global Precious Metals Code (PTE Principle 5.6).[19]

Size

Industry respondents noted their views that there are various factors that dealers will consider when deciding whether or how to pre-hedge and there are no clear order or quote size 'rules' that govern the practice.

These include market factors, such as notional size of the individual transaction, market liquidity, the time of day, market conditions and non-market factors such as the client's execution need and the risk that the dealer is willing to assume. Liquidity can depend on the characteristics of the specific financial instrument or asset class and the predominant trading structure of the market.

Among some industry respondents, there was a view that pre-hedging is most likely to realise benefits for dealers and clients in situations where trades are large in size relative to the liquidity of the market for a financial instrument or in times of greater volatility.

Asset classes

The predominant view from industry respondents is that the suitability of pre-hedging is not dependent on the specific asset class but contingent on the factors of the structure of the market of the individual financial instrument.

Transacting in some asset classes, such as fixed income, commodities, and FX, is more likely to be subject to pre-hedging. Industry respondents noted this is driven by a predominance of principal liquidity providers in those markets and the use of RFQs, rather than agency relationships or lit order book structures

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[19] FMSB Large Trades Standard: https://fmsb.com/wp-content/uploads/2021/05/FMSB_Large_Trades_Standard_-FINAL-05.05.21.pdf, fx global: https://www.globalfxc.org/uploads/fx_global.pdf, global precious metals code: https://www.juliusbaer.com/fileadmin/legal/global-precious-metals-code.pdf

more common in equity markets. Respondents noted that pre-hedging is used in many markets for RFQs.

Competitive RFQs

Among the industry respondents, there were different views and no clear industry consensus on whether pre-hedging is appropriate in competitive RFQs without affirmative consent from the client.

Some industry respondents raised concerns that pre-hedging in a competitive RFQ environment could result in dealers adversely affecting the price and/or liquidity of the financial instrument and leading to the client obtaining a worse execution than if there had been no pre-hedging. This would be primarily due to dealers amplifying the size of the order through duplicative pre-hedging activities. In particular, these respondents noted that:

1. Pre-hedging in competitive RFQs relies on the assumption that the dealer will secure the trade.

2. There is a risk of price slippage due to the cumulative effect of pre-hedging transactions. This situation would arise if an investor requested a price from several dealers and some or all of them pre-hedged the transaction.

3. Pre-hedging poses a risk to competition in that a dealer who chooses to pre-hedge could trigger a movement in the observable price of the financial instrument. This, in turn, could impact the subsequent quotes offered to the client by other dealers, as they may reference market prices and provide less favourable prices to the client. In this circumstance the 'first mover advantage' of the dealer choosing to pre-hedge could render the pre-hedging dealer better positioned to win the trade.

Other industry respondents supported the practice of pre-hedging in competitive RFQs because it enables dealers to offer prices where they may ordinarily not be able to do so, and fosters competition. Dealers that do not have inventories of the financial instruments that they are being requested for quoting may not be willing to offer a price in the absence of pre-hedging. Therefore, pre-hedging can potentially increase competition and lower costs for clients. Without pre-hedging, only certain dealers with inventory may be able to offer a price to the client.

IOSCO recognises that this practice is an area with differing views. Set out below in chapters 6 and 7 are proposed recommendations as guidance for IOSCO members to consider on the circumstances where pre-hedging may be acceptable and on ways to mitigate conduct risks from pre-hedging.

Industry codes and standards

We have observed that industry codes and standards on pre-hedging may vary across institutions, asset classes and financial instruments. For some asset classes, such as FX and precious metals, there are industry guidelines and codes of conduct: FX Global Code and the Global Precious Metal Code. These codes of conduct have been developed in OTC markets, where central banks have a large presence. These codes incorporate several principles including how to treat specific information on client transactions in those markets.

In comparison, for other regulated asset classes, such as equities and fixed income, industry standards are less developed in relation to pre-hedging. Respondents to the industry survey commented that there were no globally adopted industry standards on how to undertake pre-hedging. Although there has been some work done by the FMSB to close this gap, developing the FMSB Standard on Large Trades in FICC markets in 2021[20], which sets out under Core Principle 7 that for dealing with large orders, pre-hedging should only be undertaken where:

(i) "*the dealer legitimately expects to take on market risk and the pre-hedging is undertaken at the dealer's own risk.*
(ii) *the trading activity is reasonable relative to the size and nature of the anticipated transaction.*
(iii) *it aims to minimize the impact of the activity on the market; and*
(iv) *it is designed to benefit the client and not executed in a manner that is meant to disadvantage the client*"."

Some broadly consistent principles apply across the industry standards and codes mentioned above. One of these principles restricts the definition of pre-hedging to principal trading or dealing for a dealer's own account in connection with a client order. This specific definition highlights the contrast with agency trading, where transactions are done on behalf of clients and booked directly (one-on-one) into the client account. When trading in an agency capacity, the industry standards and codes note that there is no market risk for the broker-dealer and hence such activity should not be considered a form of pre-hedging.

The FX Global Code,[21] developed from a partnership between central banks and market participants, the Global Precious Metal Code and the FMSB Standard on Large Trades[22] are well-known examples of industry responses designed to improve conduct and raise standards. Standard setters do not

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20 Standard for the execution of Large Trades in FICC markets: https://fmsb.com/wp-content/uploads/2021/05/FMSB_Large_Trades_Standard_-FINAL-05.05.21.pdf

21 See page 17, Principle 11 on pre-hedging, and Illustrative Examples,Annex 1, pages 55-56: https://www.globalfxc.org/fx_global_code.htm

22 See page 8-10: https://fmsb.com/wp-content/uploads/2021/05/FMSB_Large_Trades_Standard_-FINAL-05.05.21.pdf

have monitoring, oversight, supervision, or enforcement mechanisms for ensuring that dealers adhere to the standards which they may have agreed to adopt. They also have limited scope, target specific asset classes, and do not cover the whole spectrum of issues related to pre-hedging.

Despite the value of industry codes and standards on pre-hedging, industry respondents noted that certain regulators and market participants have expressed the view that there remains significant uncertainty for dealers, particularly where dealers are active across multiple jurisdictions or asset classes that may not take industry codes and standards into account. This potential for uncertainty expressed by certain regulators and market participants, could, according to industry respondents, undermine competitive neutrality and efforts to improve outcomes for clients through pre-hedging.

Chapter 5. Definition of Pre-hedging

There are various definitions of pre-hedging globally.

Currently, there is no globally agreed definition of pre-hedging, but some authorities and standard setters have published definitions.

In a Call for Evidence published in 2022,[23] ESMA defined pre-hedging as:

> *"any trading activity undertaken by an investment firm, where*
>
> *(i) the investment firm is dealing on its own account, and the trading activity is undertaken,*
>
> *(ii) to mitigate an inventory risk which is foreseen due to a possible incoming transaction,*
>
> *(iii) before that foreseeable transaction has been executed; and*
>
> *(iv) at least partially in the interest and benefit of the client or to facilitate the trade."*

FX Global Code[24] defines pre-hedging as:

> *"the management of the risk associated with one or more anticipated client orders, designed to benefit the client in connection with such orders and any resulting transactions."*

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23 ESMA70-449-672 Call for Evidence on pre-hedging: https://www.esma.europa.eu/sites/default/files/library/esma70-449-672_call_for_evidence_on_pre-hedging.pdf. See also the 2023 Report: https://www.esma.europa.eu/sites/default/files/2023-07/ESMA70-449-748_Feedback_report_on_pre-hedging.pdf)

24 Annex 2, page 75: https://www.globalfxc.org/fx_global_code.htm. The FX Global Code July 2021 (Global Code) is a set of global principles of good practice in the foreign exchange market, developed to provide a common set of guidelines by a partnership between central banks and Market Participants from 20 jurisdictions around the globe. The FX Global Code was created with global input and negotiation between public and private sectors (including buy and sell side, infrastructure providers, central banks and national regulators). In FX markets, pre-hedging is subject to Principle 11 of the FX Global Code which states that a "market participant should only pre-hedge client orders when acting as a principal and should do so fairly and with transparency". The FXGC further states that "pre-hedging should be done with the intent to benefit the liquidity consumer and facilitate the trade. Any trading activity after the acceptance of the firm quote by the liquidity consumer is deemed hedging". In addition, "liquidity providers should carefully establish guidelines and controls for when pre-hedging is appropriate based on their risk appetite and underlying liquidity conditions" (see Global Foreign Exchange Committee: Commentary on Principle 11 and the role of pre-hedging in today's FX landscape).

IOSCO believes that it is important to derive a common definition of pre-hedging to facilitate international regulatory alignment.

For the purposes of this consultation report, IOSCO proposes to define **pre-hedging** as:

"*trading*[25] *undertaken by a dealer, in compliance with applicable laws and rules, including those governing frontrunning, trading on material non-public information/insider dealing, and/or manipulative trading: 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 and before the client (or an intermediary on the client's behalf) has agreed on the terms of the transaction[26] *and/or irrevocably accepted an executable quote; and*
(iii) the trades are executed to manage the risk related to the anticipated client transaction."

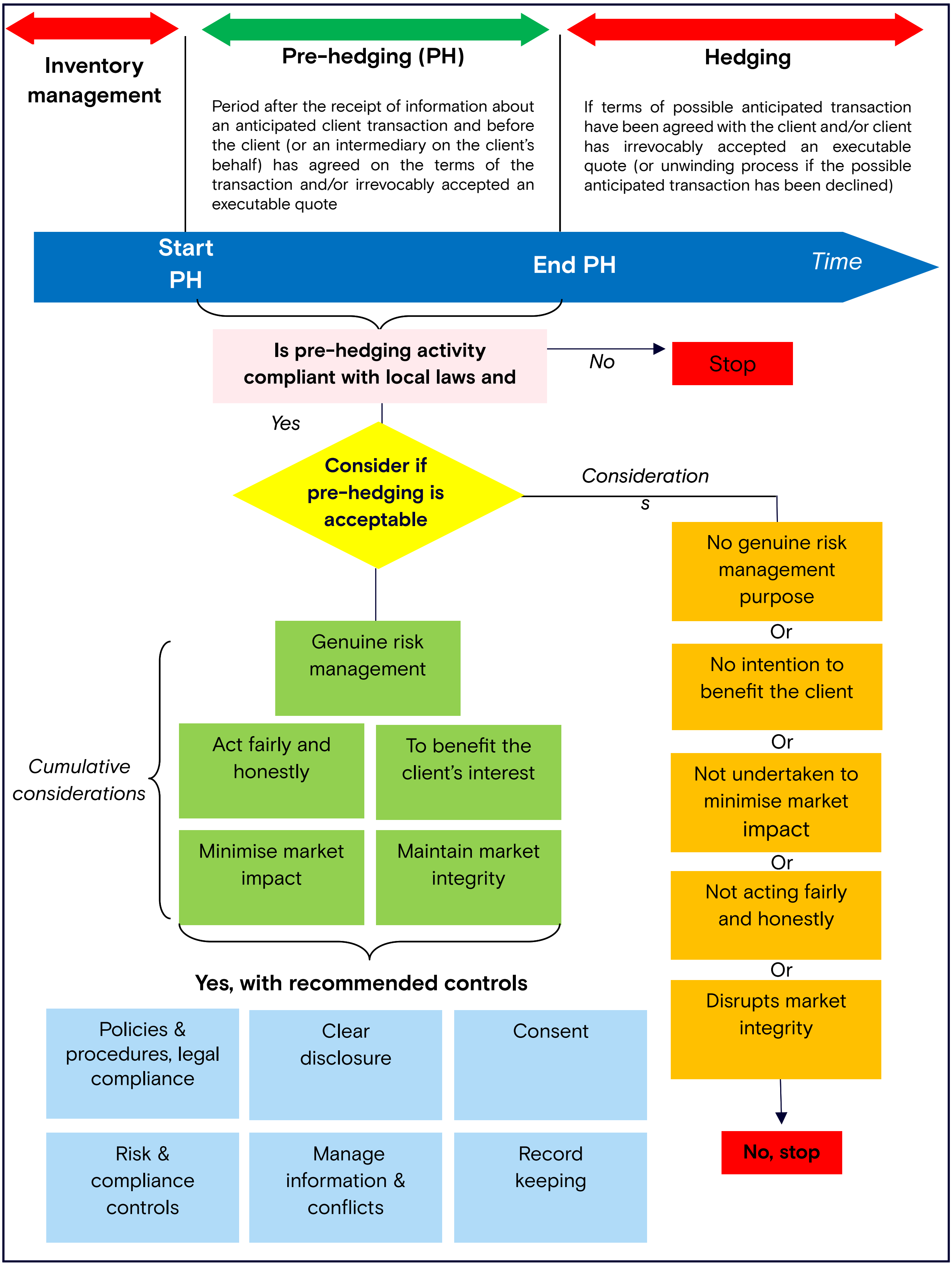
Consultation Question
1. Do you agree that this is the correct definition of pre-hedging? If not, how would you define pre-hedging?

The following schematic provides a proposed diagrammatic overview of when pre-hedging occurs alongside inventory management and hedging.

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 possible anticipated client transaction should be considered as "hedging", not pre-hedging.

Figure 1: Pre-hedging schematic



Chapter 6. Recommendations for Determining When Pre-hedging is Acceptable

Pre-hedging in the right circumstances, according to the dealer's risk appetite and with the right controls can support the effective functioning of the market by facilitating trades that might otherwise have a significant impact on market pricing. Pre-hedging can help to manage market risk for dealers when providing liquidity to clients and can lead to beneficial outcomes for clients. However, in the wrong circumstances or with poor controls, pre-hedging can present risks to market integrity and potentially harm clients.

We set out in this chapter proposed cumulative recommendations as guidance for IOSCO members to consider when determining the circumstances in which pre-hedging is acceptable, including questions for consultation.

We then discuss in greater detail the recommendations for when pre-hedging is acceptable including consideration of the potential benefits for clients, dealers and the market, as well as potential risks that can arise if pre-hedging is inappropriately undertaken or controlled. The recommendations have been structured around the following key factors:

a) genuine risk management purpose
b) acting fairly and honestly
c) to the benefit of the client
d) minimising market impact
e) maintaining market integrity

The proposed recommendations are provided as guidance for IOSCO members to consider in relation to pre-hedging and the guidance applies to both primary and secondary transactions.

Recommendations for determining when pre-hedging is acceptable:

IOSCO members should consider the following cumulative recommendations as guidance, taking into account their relevant legal and regulatory frameworks. IOSCO members can then consider how they wish to apply these recommendations to dealers in their local jurisdictions.

Consistent with any existing jurisdictional obligations:

- **Recommendation A1: Dealers should undertake pre-hedging only for a genuine risk management purpose.**

➢ **Recommendation A2: Dealers should (i) act fairly and honestly to clients and (ii) undertake pre-hedging only with the intention to benefit the client.**

➢ **Recommendation A3: Dealers should (i) minimise market impact and (ii) maintain market integrity when pre-hedging.**

Analysis of the recommendations for determining when pre-hedging is acceptable

➢ **Recommendation A1: Dealers should undertake pre-hedging only for a genuine risk management purpose.**

Genuine risk management purpose
In this context, IOSCO identifies three main types of risk management purposes:

- Pre-hedging can be an important tool for dealers to manage their market risk exposure from anticipated client transactions by allowing them to accumulate offsetting positions and reduce their risk.

- Pre-hedging lengthens the duration of time the dealer has to manage risk to include the period prior to receipt of the client making an irrevocable agreement to deal or accepting an executable quote from the dealer. This may reduce the market impact to the dealer and client and lower the overall transaction costs. While the net effect of pre-hedging practice on pricing is unclear, a reduction in market risk for dealers may potentially enable them to provide a better quote to the client.

- Dealers may use pre-hedging to 'test' market prices and liquidity by assessing market depth, particularly where the market for the financial instrument is characterised by low liquidity, or if the anticipated transaction is large relative to the market absorption capacity. Depending on the specific asset class and market structure, the level of 'observable' liquidity may be different to 'actual' liquidity. The ability to 'test' actual liquidity using pre-hedging can particularly benefit products traded on OTC markets, where pre-trade price transparency can be lower. IOSCO understands that in this case it is possible to pre-hedge the anticipated client transaction before providing an executable quote.

In determining whether there is a genuine risk management purpose, it is important for dealers to consider: (a) having a legitimate expectation of a client transaction; (b) available liquidity; (c) market conditions; and (d) the extent of pre-hedging that is required (i.e., proportionality).

Consultation question:

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?*

1. *Legitimate expectation of a client transaction*

The decision by a dealer to pre-hedge should have a genuine intention to offer an executable quote to the client and consider the likelihood of the transaction taking place with the client. This would help to ensure that the dealer seeking to facilitate the client transaction can demonstrate it has a genuine risk management purpose.

The assessment by the dealer of whether there is a legitimate expectation of a transaction from a client would likely be undertaken on a case-by-case basis. The assessment could take into consideration a range of factors, including, but not limited to, whether dealers know if they are competing with other dealers, the relationship with the client, the past dealing history of the client, and the expected competitiveness of the executable quote offered.

2. *Available liquidity*

Dealers may use pre-hedging for risk management where they reasonably assess that there may not be sufficient liquidity to effectively or efficiently manage their exposure if they execute an anticipated transaction in a financial instrument with a client. For example, dealers might consider the relative size of a transaction compared to the available trading volume of the relevant financial instrument or a correlated instrument, although other characteristics of the particular transaction or instrument may also be relevant

Without the use of pre-hedging, dealers may require a significant amount of time to ‘trade out’ of or hedge exposures that have arisen as a result of executing the client transaction. During that period the dealer will be exposed to market risk. To cover this additional risk without pre-hedging, dealers may need to quote a wider spread to the client. In cases where dealers may be exposed to market risk for an extended period, pre-hedging allows intermediaries to build up offsetting positions prior to executing the anticipated transaction and thereby lengthening the window for the intermediary to manage the various risks arising from large transactions or in illiquid markets.

Dealers may also consider both the liquidity available to manage the outright risk of the financial instrument or the basis risk associated with hedging the financial instrument using a correlated instrument that may result from an anticipated transaction (e.g., using derivatives to manage interest rate risk or credit risk from a corporate bond). It may be difficult to pre-hedge outright risk in a short period of time due to lack of liquidity available for the financial instrument of the anticipated transaction. Instead, the dealer may focus on pre-hedging its risk exposures for an anticipated transaction by trading in more liquid correlated instruments.

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

*3. **Market conditions***

Liquidity can be difficult to predict and is not static. Even in very liquid markets the level of liquidity can vary depending on the time of day (e.g., market opening and closing periods) and market conditions on the day (e.g., around market-sensitive news announcements).

*4. **Proportionality in pre-hedging***

Pre-hedging should be used by a dealer for genuine risk management purposes to manage an expected future position arising from an anticipated client transaction. A number of factors may be considered by a dealer when determining the percentage of the anticipated client transaction to be pre-hedged.

Firstly, if pre-hedging does not fully offset the risk of the transaction, there will be some residual risk that the dealer may seek to hedge after the transaction has taken place.[27]

Secondly, depending on the degree of liquidity of the financial instrument and/or the market conditions at the time of the transaction, dealers will need to consider the effect of their pre-hedging on prices and consider the relative reasonable size of pre-hedging activity. IOSCO believes that pre-hedging should not move prices against the client's interest and should be used with the intention to benefit a client.

Third, pre-hedging more than the anticipated full amount of a client transaction may not meet the objective of genuine risk management and is more likely to negatively impact market integrity and result in a worse outcome for the client.

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[27] This is also a key principle of FX Global Code, the Precious Metals Code and the FMSB Standard on Large Trades that pre-hedging is undertaken in a manner relative to the transaction. The FX Global Code commentary on Principle 11 states that 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".

Consultation questions:

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?*
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.*

➢ **Recommendation A2: Dealers should (i) act fairly and honestly to clients and (ii) undertake pre-hedging only with the intention to benefit the client.**

Act fairly and honestly

The conduct of dealers is subject to jurisdictional laws and regulations, which may require the dealer to act fairly and honestly. Compliance with these existing laws and regulations should mitigate the risk that a dealer could unfairly use information about an anticipated client transaction for its own benefit and at the expense of the client. For example, a dealer could use information about an anticipated transaction by taking a risk position or reducing its risk exposure in a way that may adversely affect the expected client transaction. This position could be in the financial instrument that the client is seeking to transact or in correlated financial instruments.

Clients rely on the fairness and honesty of dealers when being provided information related to an expected transaction. They may have expectations that dealers disclose their pre-hedging and hedging practices, seek the clients' consent before pre-hedging and not use the information for purposes other than to benefit the client.

To the benefit of the client

When a dealer is considering whether to pre-hedge, it should act with the intention to benefit the client and undertake pre-hedging activity in accordance with any terms agreed with the client.

ESMA's analysis concluded that a core purpose of pre-hedging is to act in the interest of the client. Likewise, Principle 11 of the FX Global Code establishes that "Pre-Hedging is the management of the risk associated with one or more anticipated Client orders, *designed to benefit the Client* in connection with such orders and any resulting transactions". Similarly, Core Principle 7 of the FMSB's Standard on Large Trades requires that pre-hedging should only be undertaken when it is designed to benefit the client and not executed in a manner that is meant to disadvantage the client.

IOSCO recommends that dealers should undertake pre-hedging with the intention to benefit the client. In this context, the dealer should consider factors such as the client's instructions regarding pre-hedging, price,[28] speed of execution, expected market impact, trade size and liquidity, and an overriding responsibility to treat the client fairly. This recommendation does not mean that every individual pre-hedging trade guarantees the best possible outcome for the client. However, the dealer should be able to demonstrate it reasonably considered these relevant factors in forming its intention to benefit the client before undertaking pre-hedging activity. These recommendations do not create an obligation to share all financial benefits derived from pre-hedging with the client.

Consultation questions:
7. *Do you agree with the concept of client benefit described above?* 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.* 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?*

➢ **Recommendation A3: Dealers should (i) minimise market impact and (ii) maintain market integrity when pre-hedging.**

Minimising market impact

A client requesting a quote from multiple dealers who pre-hedge may incur greater price slippage as the pre-hedging impacts the market price. Pre-hedging by one or more of the dealers may impact the price and availability of liquidity for the client, creating slippage costs for the client and potentially resulting in a worse outcome (e.g., a higher overall cost). This may also impact the prices for others who are trading in the market (and who do not have the benefit of the information about a prospective trade). In a competitive RFQ situation where there is a risk of multiple dealers pre-hedging, any slippage costs may be amplified.

Some dealers have raised concerns about price slippage following certain pre-hedging practices. An example of pre-hedging resulting in potential price slippage was illustrated in the Australian Federal Court case in which the clients

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[28] In the case of pre-hedging a financial contract involving derivatives, the overall benefit for the client should consider not only the offered spot price but also possible future costs occurring during the life of the contract (e.g. additional fee charged to the client in case of excessive unexpected volatility or other disruption events).

were severely prejudiced due to unconscionable pre-hedging.[29] The court declared that the dealer was aware that the pre-hedging had the potential to increase the prices of the products it traded and thereby the price of the client transaction, where every basis point increase to that price would involve a cost to the client of about $4.7 million.

Under this recommendation, dealers should minimise market impact, including adverse impact to the client and other market participants. IOSCO notes that this principle has been reflected in industry standards in other areas.[30] However, IOSCO acknowledges that it may not always be possible for dealers to ensure pre-hedging does not result in market movements.

Additionally, dealers also need to consider how positions built as part of a pre-hedging strategy that are not ultimately needed in connection with a client transaction (e.g., where an expected transaction is not entered into) are to be closed out without disrupting or adversely impacting market integrity.

Maintaining market integrity

Pre-hedging, if undertaken inappropriately or dishonestly can adversely impact market integrity and may not be consistent with the intention to benefit the client. There is a risk that dealers may not always use pre-hedging for genuine risk management purposes. For example, where they believe they are unlikely to execute the client's transaction, dealers may use pre-hedging contrary to the intention to benefit the client in order to secure a larger profit from the client transaction.

Consultation question:

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 the dealer to minimise market impact and maintain market integrity prior to unwinding any pre-hedging position?*

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[29] Australian Securities and Investments Commission vs Westpac Banking Corporation: https://www.judgments.fedcourt.gov.au/judgments/Judgments/fca/single/2024/2024fca0052

[30] FMSB Standard on Large Trades and the GFXC refers to "It should aim to minimise the impact of the activity on the market".

Chapter 7. Management of Conduct Risk from Pre-hedging

Pre-hedging can potentially, in some circumstances, create conflicts of interest between a client and the dealer. IOSCO recommends that dealers implement robust arrangements to ensure that any conflicts of interest are appropriately managed and to prevent trading in a manner inconsistent with applicable laws and regulatory requirements.

In this chapter, we set out recommendations for IOSCO members to consider, taking into account their own legal and regulatory frameworks, about the arrangements dealers should have in place to manage conduct risk arising when pre-hedging occurs.

We then discuss these arrangements in greater detail, with reference to existing practices obtained from our survey responses from IOSCO members and industry participants.

Summary of arrangements:

a) Policies and procedures
b) Disclosure
c) Consent
d) Compliance and supervision arrangements
e) Manage information and conflicts
f) Record keeping

Recommendations for managing conduct risk from pre-hedging

IOSCO members should consider the following recommendations as guidance, taking into account their relevant legal and regulatory frameworks. IOSCO members can then consider how they wish to apply these recommendations to dealers in their local jurisdictions.

Consistent with any existing jurisdictional obligations:

- **Recommendation B1: The dealer should document and implement appropriate policies and procedures for pre-hedging.**

- **Recommendation B2: The dealer should provide clear disclosure to clients of the dealer's pre-hedging practices.**

- **Recommendation B3: The dealer should obtain prior consent from the client.**
- **Recommendation B4: Dealers should implement appropriate compliance and supervisory arrangements for pre-hedging including:**

  I. **Supervisory systems and reviews; and**
  II. **Trade and communications monitoring and surveillance**

- **Recommendation B5: Dealers should appropriately manage access to, and prohibit misuse of, confidential client information and adequately manage any conflicts of interest that may arise in relation to pre-hedging. Dealers should consider establishing, monitoring, and regularly reviewing appropriate physical and electronic information controls to align with any changes to the dealer's business risk profile.**

- **Recommendation B6: The dealer should maintain adequate records of pre-hedging to facilitate supervisory oversight, monitoring, and surveillance.**

Analysis of the recommendations for managing conduct risk from pre-hedging

- **Recommendation B1: The dealer should document and implement appropriate policies and procedures for pre-hedging.**

Policies and procedures

To prevent and detect misconduct when pre-hedging, dealers generally have policies and procedures setting out internal processes to manage and control conduct risks arising from pre-hedging. It is important that these policies and procedures are tailored to the pre-hedging conduct risks that arise in each dealer's business activities. This is recognized in existing standards and guidance in other areas, such as the GFXC's guidance[31] and FMSB's Standard on Large Trades.[32] These policies and procedures may cover:

i. Identification, assessment, management, prevention and avoidance of pre-hedging conduct risks and adherence to relevant standards of behavior.
ii. Mapping of pre-hedging conduct risks identified to internal controls.
iii. Ensuring robust information barriers.

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[31] In order to engage in pre-hedging, liquidity providers should have in place procedures for handling client orders fairly and in accordance with the Code, including all the applicable Principles. These procedures are part of an appropriate control and compliance framework, which will also include oversight for the accurate monitoring of a liquidity.

[32] Principle 5 of the FMSB's Standard on Large Trades.

iv. Targeted and effective monitoring and surveillance of trading activities and communications.
v. Client complaint process to enable the review of any perceived misalignment of expectations on specific execution outcomes.
vi. Governance and oversight arrangements.
vii. Training on the firm's policy and procedure requirements for conducting pre-hedging.

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

- **Recommendation B2: The dealer should provide clear disclosure to clients of the dealer's pre-hedging practices.**
- **Recommendation B3: The dealer should obtain prior consent from the client.**

Disclosure and consent

Appropriate disclosure of pre-hedging and consent to such practices by the client, are indicators of fair and honest dealing. However, consent alone would not relieve a dealer from any other jurisdictional legal and regulatory obligations. IOSCO recommends that dealers should communicate in a manner that is clear and not misleading, and relevant to the trading environment.

When pre-hedging practices are known to the client, it can enable the client to make an informed decision when selecting a preferred dealer, and to monitor and assess whether pre-hedging is to their benefit. Clear disclosure about a dealer's pre-hedging practices may mean that clients:

i. are aware of a dealer's intention to pre-hedge and can give informed consent to the use of the confidential order information.
ii. are aware of the potential market impact from the pre-hedging; and
iii. are aware that pre-hedging may influence the quote they receive from the dealer, and the quote may therefore differ markedly in a competitive quote environment than if pre-hedging was not undertaken.

The Global FX Committee's Principle 11 (pre-hedging) notes that "*Market Participants should communicate their Pre-Hedging practices to their clients in a manner meant to enable Clients to understand their choices as to* *execution."*[33] Similar content can be found in the FMSB Standard on Large Trades.[34]

A common method used by dealers to act fairly and honestly with clients is to disclose their use of pre-hedging ahead of engaging in pre-hedging for an anticipated transaction. Disclosure can take various forms, but all disclosure should communicate pre-hedging execution practices to inform the client that pre-hedging may be used.

There is currently no standard practice on how dealers disclose the use of pre-hedging to their clients or the form of that disclosure. This has resulted in a range of approaches to disclosure including upfront disclosure, trade-by-trade disclosure, and post-trade disclosure. We note that dealers may use a combination of disclosure practices or choose not to disclose to their clients their pre-hedging practices at all.

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

Upfront Disclosure

Upfront disclosure is commonly used by dealers to disclose their pre-hedging practices. The nature of this disclosure is varied but typically covers the dealer's definition of pre-hedging, its general rationale for pre-hedging, and may list out the types of transactions or circumstances where it may pre-hedge.

Some dealers may only provide upfront disclosure to disclose their pre-hedging practices. For example, terms of business typically include a range of

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33 This principle was further elaborated in the Commentary to Principle 11: "*In general, when conditions potentially warrant pre-hedging, liquidity providers should strive to communicate the potential implication of the order on market liquidity and price. In addition, and depending on the client relationship and the perceived urgency of the trade, liquidity providers should also strive to outline alternative options for executing the trade to limit its market impact. The frequency and extent of any such discussions may also depend on the sophistication of the liquidity consumer and the perceived size of the market impact of the trade*".

34 Given their deep market knowledge, dealers are generally best placed to determine whether a transaction (or group of transactions) is likely to constitute a Large Trade. Where the dealer has the requisite information to make such a determination, before execution of a transaction, it should make a reasonable assessment of whether such transaction is likely to constitute a Large Trade in the relevant market based on the information available to it at that point in time. Where Large Trades are contemplated, the dealer is responsible for communicating this to the client and taking reasonable steps to inform the client of factors it considers relevant for transactions characterised as Large Trades, such as the: (i). role and capacity in which the dealer is acting; (ii.) execution strategy, e.g. timing or potential market impact of the transaction; (iii.) management of confidential information flows relating to the execution of the Large Trade, both by the client and the dealer; and (iv.) market performance, for example where the market performs in an unexpected manner.

matters of which a reference to the use of pre-hedging will be one. Once clients agree to the terms of business (either through affirmative or negative consent), dealers rely on this as explicit or implicit consent by the client for pre-hedging.

Consultation questions:
13. *Should upfront disclosure be applicable irrespective of factors such as the size and complexity[35] 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?* 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.*

<u>Trade by Trade Disclosure</u>

Trade-by-trade disclosure is the process whereby a dealer discloses its intention to pre-hedge ahead of a specific anticipated transaction. This can include a high-level summary of how the dealer proposes to pre-hedge (i.e., a pre-hedging strategy and rationale). The disclosure may be made through common means of trading communications, such as in an instant message, a recorded phone line, or sent via email prior to the dealer engaging in pre-hedging activity. Some industry stakeholders stated that effective pre-trade disclosure requires dealers to provide trade-by-trade disclosure to clients prior to the use of pre-hedging.

Some dealers reported they provide trade-by-trade disclosure to clients where the anticipated transaction is large and/or complex. These types of transactions are generally negotiated bilaterally and involve a longer lead time, where the dealer has more opportunity to discuss its pre-hedging strategy and rationale with its client. Given the size of these transactions, the clients involved may be more interested in understanding the impact of pre-hedging on their trade execution, cost, and pricing. One IOSCO member reported that these types of transactions may also involve third party hedge advisors appointed by the client, who may play a key role in educating clients about pre-hedging and may request information about the use of pre-hedging from dealers.

Some industry survey respondents have queried the practicality and usefulness of trade-by-trade disclosure for all pre-hedging trades and noted that disclosure should be considered based on the type of client and nature of the transaction. For example, some respondents do not believe that trade-by-trade disclosure is practical for competitive RFQs sent on electronic trading platforms, as these are largely executed by automated trading algorithms, and dealers may not have a direct relationship with clients.

35 Size and complexity to be interpreted considering the liquidity of the underlying asset.

Certain industry respondents noted that sending competitive RFQs on electronic trading platforms typically involve smaller trade sizes and that the ability to provide trade-by-trade disclosure is not a function generally available on these platforms and would require systems changes. Trade-by-trade disclosure would also place an administrative burden on platform providers and dealers. Industry respondents have also suggested that clients on electronic trading platforms are generally sophisticated institutional investors who may not need disclosure and would prefer to avoid delay in the speed at which their trades are being executed.

Consultation questions:
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.* 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? Please elaborate.*

Post Trade Disclosure

Post-trade disclosure is used where the dealer discloses to its client a summary of how the pre-hedging was executed and the overall client outcome. This reporting is typically part of a dealers' post-transaction reporting to a client in a large or material transaction. The dealer may disclose a summary of the instruments that the dealer's pre-hedging activities related to, which informs the client about the steps the dealer took to minimise market and price impact.

Post-trade disclosure is presently not a common practice among dealers. In some instances, dealers may have conducted internal reviews of large and/or complex transactions that used pre-hedging, but the findings may only be provided to clients on request.

IOSCO received mixed views in relation to the effectiveness of dealers providing post-trade disclosures to clients when pre-hedging has been used. Some industry respondents to the survey did not believe that post-trade disclosure or only limited disclosure was required when a transaction is conducted at arm's length. This is because dealers may be performing their own commercially sensitive risk management arrangements. The pre-hedging strategy may be part of the dealer's overall risk position management and not just that of the client's transaction.

Consultation questions:

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

Consent

IOSCO understands that in the context of bilateral OTC transactions, when clients agree to the terms of business (either through affirmative or negative consent), dealers may rely on this as explicit or implicit consent by the client for pre-hedging.

ESMA requested the views of market participants on whether client consent would be feasible in all types of contexts.[36]Most responses provided to the ESMA consultation considered that the collection of the client's consent for each transaction is not feasible for electronic trading. In this context, European market best practices at that time included a general disclosure (for example through the website), whereas ad hoc specific disclosure was provided only where necessary. Two respondents to ESMA's consultation stated that it would be technically feasible to express consent on a trade-by-trade basis through electronic means such as single or multiple dealer platforms or application programming interfaces (API).

Consultation questions:

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.*
21. *Should dealers be required to obtain explicit prior consent to pre-hedge for certain types of transactions? Please elaborate your response to the*

[36] Paragraphs 124 onwards: https://www.esma.europa.eu/sites/default/files/2023-07/ESMA70-449-748_Feedback_report_on_pre-hedging.pdf

question for bilateral OTC transactions, for competitive RFQ systems and for those in electronic trading platforms.

> **Recommendation B4: Dealers should implement appropriate compliance and supervisory arrangements for pre-hedging including:**
> **I. Supervisory systems and reviews; and**
> **II. Trade and communications monitoring and surveillance.**

Compliance and supervisory arrangements

Robust and appropriately resourced compliance and supervisory arrangements across a dealer's front office and risk and compliance teams are recommended by IOSCO to ensure the effective implementation of the policies, procedures, and controls for pre-hedging. IOSCO believes that this enables dealers to ensure that pre-hedging is undertaken in alignment with the dealer's policies and procedures and associated controls regarding when and how pre-hedging is acceptable. To detect whether pre-hedging practices have been conducted: for genuine risk management purposes; for the benefit of the client; and to minimise market impact, some dealers have arrangements in place to conduct a post-trade review of pre-hedging activity, and the execution outcome for the client. This may involve reviewing recorded details of the client enquiry, pre-hedging trading activity (amount, time period, financial instruments traded, team members involved), and analysis of relevant price movements during the period in which pre-hedging was undertaken.

FMSB's spotlight report recognises that post-trade review of the market and client impact of pre-hedging can help promote confidence among clients and other stakeholders that a dealer's pre-hedging activity was designed to benefit clients.[37] The report states that when dealers receive requests from clients concerning Large-Trades, dealers should provide, where possible, the general observed impact of pre-hedging activity on client execution (subject to appropriate confidentiality and information handling restrictions).[38]

Consultation question:

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?*

> **Recommendation B5: Dealers should appropriately manage access to, and prohibit misuse of, confidential client information and adequately**

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[37] FMSB Pre hedging: Case Studies, at p. 9

[38] FMSB Pre hedging: Case Studies, at p. 11

manage any conflicts of interest that may arise in relation to pre-hedging. Dealers should consider establishing, monitoring, and regularly reviewing appropriate physical and electronic information controls to align with changes to the dealer's business risk profile.

Manage information and conflicts

To protect the confidentiality of information from an anticipated transaction, dealers generally have physical and electronic controls (i.e., information barriers) in place to manage confidential information. These information barriers prevent inappropriate sharing of, or unauthorised access to, confidential client information that may arise from the client enquiry and resultant pre-hedging.

Some dealers have special information barriers in place for certain material anticipated transactions, where the trader working on the transaction is removed from the trading desk to work separately in a 'dark room'. The trader trades on a separate segregated trading book and focuses solely on executing the anticipated transaction (including any associated pre-hedging activity) and will not return to the trading desk until that transaction has been completed or declined. Whilst the trader is in the dark room, their usual trading book is managed by another trader who does not have knowledge of the anticipated transaction.

Dealers generally have policies and procedures setting out internal processes to deal with conflicts of interest arising across their businesses. However, dealers differ on the level of detail and robustness of these processes. IOSCO believes that it is important that these processes seek to cover the identification, assessment, management, prevention and avoidance of conflicts of interest with regard to pre-hedging.

In some situations, for instance when an initial client enquiry being pre-hedged is likely to be quickly followed by other ones (so called "follow-on" orders), dealers may consider strategies that combine pre-hedging with inventory management. In these circumstances it would be difficult to establish a link between any single transaction and the overall pre-hedging and inventory management activity. These strategies are higher-risk and could impact market integrity and lead to worse client outcomes.

Consultation question:

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?*

- **Recommendation B6: The dealer should maintain adequate records of pre-hedging to facilitate supervisory oversight, monitoring, and surveillance.**

Record-keeping

IOSCO believes that effective record keeping practices of pre-hedging activities support effective front office supervisory oversight and monitoring and surveillance conducted by independent control functions.

Consultation question:

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

Industry codes

Given the strong industry interest in pre-hedging, IOSCO considers it important to know whether in the view of some stakeholders the industry codes already meet some or all the proposed recommendations and, if so, explaining in detail how.

Consultation question:

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

Chapter 8. Considerations for Clients

Suggestions to clients to manage potential risks connected with pre-hedging

1. **Clients could consider seeking to minimise the potential risk of information leakage about anticipated transactions. For example, this can include sending out two-way RFQs (non-directional).**

2. **Clients could consider implementing internal controls to monitor market pricing, execution outcome, market activity and assess the quality of execution where pre-hedging has been used by a dealer.**

3. **Clients could consider, prior to providing consent to pre-hedging, enhancing their understanding of dealers' pre-hedging practices and the potential impact of pre-hedging. This can include asking the dealer for the intended pre-hedging strategy.**

4. **If a client does not want pre-hedging to be used, the client could consider informing the dealer.**

5. **The client could consider asking the dealer for information on how pre-hedging benefitted their transaction.**

Chapter 9. List of Recommendations and Consultation Questions

This report sets out proposed recommendations that IOSCO members should consider as guidance, taking into account their relevant legal and regulatory frameworks. IOSCO members can then consider how they wish to apply these recommendations to dealers in their local jurisdictions

A. Cumulative recommendations for circumstances when pre-hedging is acceptable

Consistent with any existing jurisdictional obligations:

➢ **Recommendation A1**: Dealers should undertake pre-hedging only for a genuine risk management purpose.

➢ **Recommendation A2:** Dealers should (i) act fairly and honestly to clients and (ii) undertake pre-hedging only with the intention to benefit the client.

➢ **Recommendation A3**: Dealers should (i) minimise market impact and (ii) maintain market integrity when pre-hedging.

B. Recommendations for managing conduct risk from pre-hedging

Consistent with any existing jurisdictional obligations:

➢ **Recommendation B1:** The dealer should document and implement appropriate policies and procedures for pre-hedging.

➢ **Recommendation B2**: The dealer should provide clear disclosure to clients of the dealer's pre-hedging practices.

➢ **Recommendation B3**: The dealer should obtain prior consent from the client.

➢ **Recommendation B4**: The dealer should implement appropriate compliance and supervisory arrangements for pre-hedging including:

i. Supervisory systems and reviews; and

ii. Trade and communications monitoring and surveillance.

➢ **Recommendation B5:** Dealers should appropriately manage access to and prohibit misuse of confidential client information and adequately manage any conflicts of interest that may arise in relation to pre-hedging. Dealers should consider establishing, monitoring, and regularly reviewing appropriate physical and electronic information controls to align with changes to the dealer's business risk profile.

> ➢ **Recommendation B6:** The dealer should maintain adequate records of pre-hedging to facilitate supervisory oversight, monitoring and surveillance**.**

List of Consultation Questions

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?*

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?*

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

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?*
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.*

Client Benefit

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

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?*

Policies and procedures

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

Disclosure

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

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?*
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.*

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.*
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.*

Post-trade disclosure

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

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*.

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.*

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?*

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?*

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?*

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.*

Appendix

List of IOSCO members and entities that responded to the survey

IOSCO member or entity		Jurisdiction
Australian Securities and Investments Commission	ASIC	AUSTRALIA
Securities Commission of The Bahamas	SCB	BAHAMAS
Autorité des marchés financiers	AMF	FRANCE
Bundesanstalt für Finanzdienstleistungsaufsicht	BAFIN	GERMANY
Securities and Futures Commission	SFC	HONG KONG
Commissione Nazionale per le Società e la Borsa	CONS OB	ITALY
Financial Services Agency	JFSA	JAPAN
Capital Markets Authority	CMA	KUWAIT
Securities and Exchange Commission	SEC	NIGERIA
Ontario Securities Commission	OSC	ONTARIO
Monetary Authority of Singapore	MAS	SINGAPORE
Comisión Nacional del Mercado de Valores	CNMV	SPAIN
Swiss Financial Market Supervisory Authority	FINMA	SWITZERLAND
The Dutch Authority for the Financial Markets	AFM	THE NETHERLANDS
Capital Markets Board	CMB	TÜRKIYE
Financial Conduct Authority	FCA	UNITED KINGDOM
Commodity Futures Trading Commission	CFTC	UNITED STATES OF AMERICA
Financial Industry Regulatory Authority	FINRA	UNITED STATES OF AMERICA
National Futures Association	NFA	UNITED STATES OF AMERICA
European Principal Traders Association	FIA EPTA	EUROPE
Global Financial Markets Association	GFMA	GLOBAL
Global Foreign Exchange Committee	GFXC	GLOBAL
International Swaps & Derivatives Association, Inc.	FIA ISDA	GLOBAL

External publications

FMSB: Standard for the execution of Large Trades in FICC markets

https://fmsb.com/wp-content/uploads/2021/05/FMSB_Large_Trades_Standard_-FINAL-05.05.21.pdf

FMSB: Pre-hedging case studies

https://fmsb.com/wp-content/uploads/2023/07/Pre-hedging-Case-Studies-FINAL_26.07.24-003.pdf

FMSB: Risk Management Transactions for New Issuance standard for the Fixed Income markets

https://fmsb.com/wp-content/uploads/2019/03/Risk-Management-Transactions-for-New-Issuance-standard-Final-3-July-2018_v5.pdf

Global Foreign Exchange Committee: Global Code, A set of global principles of good practice in the foreign exchange market

https://www.globalfxc.org/uploads/fx_global.pdf

Global Foreign Exchange Committee: Commentary on Principle 11 and the rol e of pre-hedging in today's FX landscape

https://www.globalfxc.org/uploads/commentary_principle_11_role_prehedging.pdf

LBMA: Global Precious Metals Code

https://www.lbma.org.uk/publications/the-code/foreword

ESMA: Report On the Call for Evidence on pre-hedging

https://www.esma.europa.eu/sites/default/files/2023-07/ESMA70-449-748_Feedback_report_on_pre-hedging.pdf