ISDA and FIA response to IOSCO's consultation report on pre-hedging

General Remarks:

ISDA and FIA ('The Associations') welcome the opportunity to respond to IOSCO's consultation report on pre-hedging.

An appropriate, consistent and well-understood framework for pre-hedging is important for safe and efficient markets. As the consultation notes, *"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…"* We agree that compliance with all applicable rules and regulations is essential for appropriate pre-hedging activity. Within applicable rules and regulations, our members have a variety of views on pre-hedging – many view it as essential for risk management and market liquidity while others have objections to it. As noted in our detailed responses below – and enshrined in existing industry codes - appropriate disclosure and transparency are key for clients to understand liquidity providers' approach to pre-hedging and structure transactions accordingly.

We also agree with IOSCO's views on the merits – and challenges - of developing a single standard across jurisdictions and asset classes. As the consultation report notes, *"Overall, the responses [to the IOSCO survey] 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."* As policymakers and market participants consider these issues, we believe it would be beneficial not to cut across existing industry codes that they have previously been involved in developing, most notably the FX Global Code, the Precious Metal Code and the FSMB Standard for Large Trades ("Global Codes"). As noted below, market participants have policies, procedures and institutional frameworks in place to comply with these Global Codes and, in many cases, such compliance is monitored by local supervisors.

Response to 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?*

The Associations acknowledge IOSCO's proposed introduction of a definition of pre-hedging, with a view to enhance global regulatory alignment across products and provide a common

understanding of the practice. The definition should be workable across jurisdictions and asset classes whilst providing a global reference for regulators and market participants. With this in mind, the Associations offer the following:

- We strongly agree that the definition of pre-hedging activities should only include those that comply with applicable laws and regulations. Reference to laws and regulations generally puts market participants on notice of these requirements. However, a non-exclusive list of possible violations is unnecessary after stating that pre-hedging must comply with such applicable laws and regulations.
- The definition should include an "intent" standard, similar to the FX Global Code. This is consistent with the later discussion in the consultation report, as well as other Global Codes.
- We recommend aligning the reference to information under limb (ii) to the approach undertaken in the opening paragraph by referring to "material information". This inclusion aims to differentiate situations in which clients share non-specific information about potential future activity or trading generally from situations in which clients share specific, actionable information about a future transaction. The receipt of such non-specific information is not expected to trigger pre-hedging requirements.
- We agree, as the IOSCO consultation suggests, that the definition of, and guidelines for, pre-hedging apply to specific transactions and not to inventory risk management.

In light of the above, we suggest the following amendments to the definition proposed by IOSCO:

"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* ***material*** *information about an anticipated client transaction and before the client (or an intermediary on the client's behalf) has agreed on the* ***material*** *terms of the transaction and/or irrevocably accepted an executable quote; ~~and~~ (iii) the trades are ~~executed~~* ***intended*** *to manage the risk related to the anticipated client transaction**;* ***and (iv) the trades are intended to benefit the client and executed in a manner that is not meant to disadvantage the client****."*

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

***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~~ **agreed** client transaction should be considered as "hedging", not pre-hedging.*

In addition, IOSCO should note that pre-hedging is only permissible in principal markets where the parties are transacting at arm's length and one does not have a fiduciary obligation to the other. Transactions in principal markets involve a liquidity/price provider (who is the one who may be pre-hedging) and a liquidity/price taker (who is seeking to execute a transaction). Accordingly, use of the term "client" should not imply a different relationship or impose additional obligations beyond those that already exist by law or contract.[1]

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?*

Pre-hedging that complies with applicable laws and regulations is the appropriate standard.

Creating a new standard – risk management that is "genuine" – potentially creates significant issues and unintended consequences for market participants. In particular, creating a parameter around what is "genuine" and what is not "genuine" in all situations for all market participants for all asset classes is challenging. In addition, certain jurisdictions, such as the UK and EU, have defined the concept of risk management for particular asset classes, including the concept of anticipatory hedging.

Similarly, any criteria for risk management should not be interpreted as exhaustive, as these may differ depending on asset class, business sector, risk profile and other factors. Considerations such as size relative to the market, market events and market volatility also determine whether a liquidity/price provider decides to pre-hedge in order to minimize market impact and reduce the risk of information leakage.

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.*

[1] Of course, a liquidity/price provider must comply with all laws and regulations that are in fact applicable to the relationship between it and the liquidity/price taker.

Liquidity is not the only factor that determines whether a liquidity/price provider needs to pre-hedge. Pre-hedging may be a beneficial risk management tool even in liquid markets.

Moreover, the definition of "sufficient liquidity" varies from market to market and even within a market, from time to time based on market conditions and from financial instrument to financial instrument. Additionally, "observable" liquidity may not be tradeable. While liquidity/price providers may be more likely to pre-hedge when they experience or perceive illiquidity, there are several challenges with using liquidity as an indicator:

- Interpretation of sufficient liquidity: A trading desk may engage in numerous transactions with clients and related hedging activities during a day. Liquidity in the relevant market may be sufficient for a single potential order but not for a cohort of transactions.
- Measurement of liquidity: Measurement of liquidity may vary according to the nature of the market. For example, liquidity in OTC derivatives fundamentally differs from liquidity in securities. Liquidity in securities may be assessed by comparing trading volumes to the amount of shares or bonds. However, in OTC derivatives the provision of liquidity may depend on market conditions, balance sheet constraints and business strategies, and is generally determined by several decentralized actors' willingness to offer hedging opportunities for certain risks.
- Liquidity may vary over time: The liquidity levels of certain markets and products can vary from month-to-month (including at different times during a month), day-to-day and intraday (e.g., between close of markets in New York and reopening of markets in Asia) in some cases. Liquidity levels can also be affected by market-specific factors and external factors such as world events.

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

It would be difficult - if not impossible - to define 'small transactions' and 'liquid markets' for cross-asset class purposes or even within an asset class, given that market conditions such as market events, volatility and time of day all may impact whether a transaction is small and whether a market is liquid.

Regardless of these definitional difficulties, liquidity/price providers may need to pre-hedge transactions that are individually not material in size for a number of reasons, e.g., managing their overall exposure resulting from of a number of small client transactions or mitigating the impact of impending market events.

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?*

Liquidity/price providers need the ability to determine the most appropriate strategy to manage risks, including anticipated risks. It may be important to consider existing inventory prior to a pre-hedging decision, but such inventory may not always be available for anticipated client transactions. Firms may have different trading book structures and positions for different clients, desks and purposes, which makes mandating the use of inventory problematic across clients, firms, jurisdictions and desks. A firm that is part of a multinational group with diverse portfolios, including products that may have similar but not identical features, would not be able to compare existing inventory across trading desks and entities in order to comply with such a requirement in fast-moving markets. In addition, in principal markets, liquidity/price providers engage in market making and related hedging activity for multiple clients, potentially necessitating the same inventory. Pre-hedging the aggregate risk may actually result in a better price for the client.

6. *What factors should dealers consider in determining the size of pre-hedging an anticipated client transaction (e.g., size, instrument type, quotation environment)? Should there be an upper limit for the pre-hedging amount? If so, what type of limits (e.g., percentage based, Greek based) are appropriate for consideration? Please elaborate your response in relation to bilateral OTC transactions and for competitive RFQ systems including those in electronic platforms.*

As stated in the part of the Pre-hedging Commentary cited in footnote 27 of the IOSCO Consultation, pre-hedging should *be "commensurate with the potential risk assumed by the liquidity provider from the anticipated order and the prevailing liquidity and market conditions."* Such factors include whether the potential transaction is 1) large relative to the liquidity provider's risk limits; 2) large relative to normally available market liquidity in the product; and 3) requested during an illiquid time of day or when conditions are illiquid.

However, we are not supportive of setting limits or thresholds for the proportion of a transaction that can be pre-hedged. As a practical matter, we query whether determining thresholds applicable across markets (or even within a single market, given the impact of market conditions) and jurisdictions, including on a cross-border basis, is feasible. Further, we note that it is not always possible for the dealer to know how likely it is to win the trade and this impacts how any cap on pre-hedging activity could be implemented.

Moreover, dealers do not always hedge on a transaction-by-transaction basis and the overall pre-hedged position may depend on asset class characteristics, market dynamics and liquidity and risk management needs. The FMSB notes that *"Pre-hedging should be reasonable relative to the size and nature of the anticipated transaction taking into account the prevailing market conditions."*

Where clients want to understand further detail about dealers' risk management activities for a particular transaction, they can request more information – as is currently the case.

Client Benefit

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

The Associations agree with the IOSCO recommendation that pre-hedging practices should be intended to benefit parties that face liquidity/price providers in principal markets,[2] and also that, as the IOSCO Consultation notes, such a *"recommendation does not mean that every individual pre-trade hedging guarantees the best possible outcome for the client."*

Furthermore, as acknowledged in the consultation report and the FMSB Standard for Large Trades, the benefit to the client can take multiple forms, for example price, speed of execution, trade size, market impact and liquidity provision. In other words, the benefit to the client cannot be measured on a transaction-by-transaction basis or based on bid-offer or direct revenue benefit alone. Therefore, dealers should consider the client's overall execution outcome when evaluating the benefit of the client.

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

As the IOSCO Consultation notes, and as the Associations agree, the benefit from pre-hedging can take multiple forms, e.g., the ability to provide a price in the first place, the actual price, speed of execution, trade size, market impact and liquidity provision, any of which may not have occurred without pre-hedging. As a result, the financial benefit of pre-hedging may not be a quantifiable amount that could be calculated pursuant to a formula.

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?

[2] A mentioned in our response to question 1, use of the term 'client' should not impose obligations beyond those that already exist by law or contract.

Please refer to our responses to question 7 and our proposed definition of pre-hedging in response to question 1.

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?

The Associations believe that dealers should strongly consider the reasonably anticipated market impact when conducting pre-hedging activities and seek measures to minimize any impact on the market.

Policies and procedures

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

The Associations generally consider many of the seven policies and procedures as appropriate measures that are aligned with general industry practices (often manifested in the Global Codes). However, certain elements (e.g., monitoring of trading activities or client complaints) are not only of relevance for pre-hedging. Dealers should have in place global market manipulation policies, anti-frontrunning policies, conduct policies and global confidential/non-public information policies, including prohibitions for certain activities, and should communicate these to clients. It is not only unnecessary but also operationally challenging for firms to have similar or duplicative functions installed solely for the purpose of pre-hedging transactions (particularly in light of the fact that dealers acting as principal continue to make markets and hedge risk for clients).

Disclosure

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

Disclosures must comply with applicable laws and regulations. General upfront disclosures on pre-hedging are workable and informative to clients, including in the context of competitive RFQs or electronic transactions. Such upfront disclosures are in line with requirements set out in the Global Codes.

Disclosure practices should be accessible to clients, ensure that terms and conditions in relation to pre-hedging practices are visible and known to both of the parties to a transaction and afford the client with the opportunity to opt-out of pre-hedging.

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?

See responses to Questions 12 and 15.

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.

In all contexts, including in the context of competitive RFQs or electronic transactions, upfront disclosure should cover whether pre-hedging may take place by the liquidity/price provider, the principles and considerations for the liquidity/price provider's use of pre-hedging to facilitate trading and manage risk and the potential impacts on the client trade. Further, disclosures should make it clear that liquidity/price providers act as principal with a view to facilitating a potential transaction and may execute portfolio risk management transactions, other client transactions or other risk management activities as pre-hedging.

We urge IOSCO to ensure that any compliance with future guidance is compatible with the application of the Global Codes, all of which require that disclosures articulate what it means to pre-hedge and the potential impact of any such activity.

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.

In general, trade-by-trade disclosures are not as practical as upfront disclosures. However, clients can demand specific disclosures for certain transactions or request additional information at the time of such transactions. Specifically, with respect to large transactions, many members generally accept FMSB guidance on trade-by-trade disclosure for bi-lateral negotiated large trades if the liquidity/price provider determines that additional disclosure is warranted based on the sophistication of the client and frequency of trading. A similar trade-by-trade approach would not be practical for certain RFQs or electronic platforms, where transactions are likely to be latency sensitive, and therefore any delay in execution as a result of trade-by-trade disclosure and/or consent would be to the detriment of the transaction and client.

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.

Please refer to our responses to Question15.

Post-trade disclosure

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

We do not support prescriptive standards for post-trade disclosures. The nature of any appropriate post-trade disclosure will depend on the transaction, market, asset class and other party to the transaction. In some cases, ex post analysis of pre-hedging practices may pose significant challenges from a practical and confidentiality perspective.

In the case of a large trade, if reasonably requested by a client and consistent with the principal nature of the relationship, and subject to appropriate confidentiality and information handling restrictions, liquidity providers could share with the client general information on the pre-hedging approach undertaken by the dealer and general market colour over that period of time.

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?

Liquidity/price providers in principal markets undertake market making and related hedging activities in respect of transactions with multiple clients and pre-hedging activity may not be isolated, making ex ante agreement on the nature and form of any post-trade disclosure impractical and potentially subject to a violation of confidentiality principles with other clients. Accordingly, market participants could instead engage with dealers on a post-trade basis based on relevant facts and circumstances.

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

Please refer to our responses to questions 17 and 18.

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.

Yes, clients should have the ability to inform their dealers that they do not want pre-hedging of their transactions. Clients can prohibit their dealers from pre-hedging on a relationship basis or in respect of a transaction. If a dealer agrees with its client not to pre-hedge and then does so, it would be an explicit breach of the contractual terms and subject the dealer to legal consequences.

21. Should dealers be required to obtain explicit prior consent to prehedge 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.

Explicit consent on a trade-by-trade basis may not be practicable in many circumstances due to the speed at which markets move, the associated client outreach required and different time zones. However, as discussed in our answer to question 12 above, upfront disclosure practices should afford the opportunity to opt-out of pre-hedging for a single transaction or all transactions with any given dealer.

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?

Dealers should use a risk-based approach to determine the appropriate post-trade review process consistent with their compliance and supervisory arrangements and proportionate to the nature of the market and transaction type.

While stand-alone post-trade reviews with clients are problematic for the reasons mentioned in the answers above to question 17-18 and below to question 23, many of our members who adhere to the Global Codes report a number of procedures and controls that are designed to monitor trade execution and client outcomes, including trade surveillance, communications surveillance, and internal supervisory and risk escalations, as well as periodic reviews of trade execution metrics by internal fair pricing and best execution committees.

In some cases, these procedures and controls have been implemented through an established risk-based monitoring program with respect to each of such member's primary lines of business and

within each applicable geographic region, and the risk assessment is reviewed periodically using a number of factors to identify where additional controls (including, but not limited to, automated monitoring models) may be required.

In addition, these members have market abuse trade surveillance functions that include front-running trade surveillance across products designed to detect instances of attempted or actual front-running. Some of these members also conduct fair pricing surveillance and review pricing metrics at fair pricing governance committees.

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?

This type of control would require dealers to be able to tag trades as inventory management or pre-hedging, and given how hedging works, this would typically only be possible, if at all, on a post-hoc basis. This capability does not exist currently, and implementing such a system would be impractical, particularly given that it may not always be possible to identify a particular trade as pre-hedging a specific trade, risk management or inventory hedging. Dealers do not cease their principal market making and related hedging activity for other clients when they engage in pre-hedging and pre-hedging activity may be inextricably linked to such other activity, particularly when a dealer is hedging its risk at a inventory level.

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?

Recordkeeping must comply with applicable law. These laws (e.g., CFTC and SEC regulations in the US and MiFID in the EU and the UK) generally require dealers to keep records necessary to reconstruct orders and transactions. In addition, communications are recorded in many cases.

The adequacy of records should be sufficient for each firm to undertake effective monitoring of pre-hedging. Whilst firms may further document large complex bilateral transactions undertaken a few times a year, such an expectation cannot be applied to RFQ trading protocols and electronic trading.

Industry codes

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

Yes, industry codes have been developed under consultation of regulators and industry participants and cover many if not all of the points in the IOSCO Consultation.

These Global Codes are long standing, widely adopted and understood within the industry. Moreover, market participants have policies, procedures and institutional frameworks in place to comply with these Global Codes and in many cases, such compliance is monitored, or even expected (e.g., adherence to the FX Global Code in the UK), by local supervisors and regulators.

About ISDA:

Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 1,000 member institutions from 77 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's website:www.isda.org. Follow us on Twitter, LinkedIn, Facebook and YouTube.

About FIA:

FIA is the leading global trade organization for the futures, options and centrally cleared derivatives markets, with offices in Brussels, London, Singapore and Washington, DC. Our membership includes clearing firms, exchanges, clearinghouses, trading firms and commodities specialists from about 50 countries as well as technology vendors, law firms and other professional service providers.