Pre-hedging: IOSCO publishes delayed Consultation Report

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Related topics: Securities and derivatives, Funds and asset management, Banking and finance

On 21 November 2024, the International Organization of Securities Commissions (“**IOSCO**”) published a consultation paper in response to concerns about the appropriateness of pre-hedging practices raised by various market participants, standard setters and national and supra-national authorities. In short, pre-hedging is the well-established practice by which dealers in certain markets look to hedge their exposure to anticipated client orders for a number of reasons, including to enable the dealer to take on the risk of the client order once confirmed, and to offer a competitive price.

Background

European Union

The European Securities and Markets Authority (“**ESMA**”) issued a call for evidence on pre-hedging in July 2022 to form a better view on its admissibility in the context of the Market Abuse Regulation (MAR), Markets in Financial Instruments Directive (MiFID) and Markets in Financial Instruments Regulation (MiFIR). In July 2023, ESMA concluded in its final report that pre-hedging could give rise to conflicts of interest or abusive behaviour, but did not find arguments to ban pre-hedging at this stage. ESMA also suggested that global regulatory principles, if established, could contribute to the development of any future ESMA guidance.

United Kingdom

The Financial Conduct Authority (“**FCA**”) has not publicly stated that it will produce specific guidance on pre-hedging, though the FCA has contributed to and been involved in IOSCO’s work in this area. Clearly, there are already various industry codes of practice that are adopted for specific markets which address pre-hedging (in particular, the FX Global Code, the Global Precious Metals Code and the Financial Market Standards Board’s (“**FMSB**”) Standard for the execution of large trades in fixed income, currencies and commodities (“**FICC**”) markets). However, as noted by IOSCO, these relate to over-the-counter (OTC) markets and/or only specific asset classes, and are generally not monitored or enforced.

Separately, the FMSB recently published a spotlight review in July 2024 on pre-hedging, containing illustrative case studies that outline good and poor practices in relation to pre-hedging for market participants. The case studies focus on trading practices across asset classes and the corresponding liquidity spectrum, in fixed income and currencies (“**FIC**”) and exchange traded funds (ETFs). They also consider the practice of risk management activity related to new issuances.

Key points of interest

Definition of pre-hedging

IOSCO’s proposed definition has a number of elements:

i. pre-hedging is undertaken by a dealer;
ii. in compliance with applicable laws and rules;

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iii. the dealer is executing on its own account in a principal capacity only;
iv. trades are executed after receipt of information about an anticipated client transaction but before agreement or quote acceptance; and
v. trades are executed to manage risk related to the anticipated client transaction.

Development of recommendations

In summary, IOSCO is proposing the following recommendations:

- **Genuine risk management purpose** – dealers should consider: (a) having a legitimate expectation of a client transaction; (b) available liquidity; (c) market conditions; and (d) the extent of pre-hedging required (i.e. proportionality).
- **Acting fairly and honestly** – clients may have expectations that dealers disclose, seek client consent and not use client information for other purposes.
- **To the benefit of the client** – the dealer should be able to demonstrate it reasonably considered the client's instructions and its responsibility to treat clients fairly.
- **Minimising market impact** – dealers should attempt to minimise market impact (IOSCO notes the impact that competitive requests for quotes ("**RFQs**") may have), though IOSCO recognises that it may not always be possible for dealers to ensure pre-hedging does not result in market movements.
- **Maintaining market integrity** – if undertaken inappropriately or dishonestly, pre-hedging can adversely affect market integrity.

Current jurisdictional practices and misconduct cases

IOSCO carried out a survey of its members, with the questions aimed at understanding the practice of pre-hedging and the related risks and mitigants members have seen in their jurisdictions. Respondents included the French Autorité des marchés financiers (AMF), which said that pre-hedging is one of the issues about which it receives the most suspicious transaction and order reports (STORs) from dealers, with 64% relating to pre-hedging in FIC instruments.

Pre-hedging is used in many markets for RFQs, and is more likely in some asset classes (FICC) than others (equities), which involve more agency relationships and lit order book structures.

Actions for firms and next steps

IOSCO invites comments on the consultation paper by **21 February 2025**.

Firms should assess whether the proposed definition and recommendations could have an impact on their businesses (e.g. requiring changes to existing policies and practices, and client disclosures). IOSCO intends to publish its final report in 2025, and its recommendations will be highly influential in guiding the approach regulators take, even if they do not commit to publishing their own guidance.

Firms should also continue to monitor whether ESMA and the FCA move to develop specific guidance in response to IOSCO's work in this area, though this is not expected at least until IOSCO's work is concluded.

In addition, firms could evaluate their current practices against the good and poor pre-hedging practices illustrated in FMSB's spotlight review (referred to above), and implement changes if necessary.

If you have any questions about the proposed changes and how these are likely to impact your firm, please get in touch with the key contacts listed or your usual contacts at CMS, who would be happy

to discuss these considerations in more detail.

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