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IOSCO's Proposed Guidance on Pre-Hedging Practices

Peter Y. Malyshev, Ivan Loncar, Michael Ena, and Robert DiNardo*

In this article, the authors discuss a consultation report published by the International Organization of Securities Commissions, concerns raised by the recommendations in the report, and how the recommendations may be implemented in the United States.

The International Organization of Securities Commissions (IOSCO) has published a consultation report[1] (Report) to provide guidance on acceptable pre-hedging practices and soliciting feedback from market participants. IOSCO recognized that, currently, few jurisdictions provide any guidance on pre-hedging practices while the number of enforcement cases is increasing. The purpose of the Report is to identify potential issues for market participants and to facilitate regulatory alignment. The Report defines what pre-hedging is, describes the circumstances when this practice is acceptable, identifies risks attendant to pre-hedging, and provides a set of recommendations (Recommendations) to which dealers, brokers, and their clients and counterparties should adhere. The Report also solicits comments from market participants on these Recommendations (the comments must be submitted to IOSCO by February 21, 2025). Ultimately, it is expected that member regulators will enact the proposed Recommendations in their respective local jurisdictions.

Although the Report is an important step in providing greater certainty to market participants on what practices would be considered acceptable pre-hedging, the current version of the Report raises several significant concerns. Below we discuss these concerns and how these Recommendations may be implemented in the United States,[2] specifically within the legal frameworks under the Commodity Exchange Act[3] (the CEA) and Commodity Futures Trading Commission (CFTC) regulations thereunder (CFTC Regulations).[4]

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Definition

The Report defines 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.[5]

Even though this definition contains several prongs describing pre-hedging practice, it is not clear why from the outset it is necessary to provide a prescriptive list of possible violations and examples of market abuse. Merely referring to "lawful trading undertaken by a dealer. . . ." would be sufficient. There could be numerous instances when a certain unenumerated practice is unlawful, or conversely, the listed practices may be lawful, excepted, or excluded from otherwise being unlawful.[6]

Next, prong (ii) should be qualified with "material" before "information" with the understanding that dealers receive a lot of information in the course of their business; however, not all that information is material and would trigger "pre-hedging" trading.

Prong (ii) also refers to dealers' counterparties as "clients"; this term should be qualified as "material." In the United States, however, the predominant practice is to structure pre-hedging transactions as arm's-length trades with counterparties acting for their own account and not as "clients." Imposing a presumption of a fiduciary relationship in an arm's-length transaction would dramatically alter the existing market practices. Therefore, the Recommendations should refer to "counterparties" instead of "clients," unless it is specifically noted that the counterparty is also a client (i.e., there is a fiduciary relationship).[7]

We note that in several recent CFTC enforcement actions, the CFTC referred to registered swap dealer (SD) counterparties as "clients"[8] with the understanding that under the CEA, as amended by the Dodd Frank Act, registered SDs must provide certain disclosures and owe certain regulatory duties to their counterparties that are not other registered SD (e.g., Part 23 of CFTC Regulations). Nevertheless, these regulatory duties do not impose fiduciary duties on registered SD with respect to their counterparties.

Also, the International Swaps and Derivatives Association (ISDA) standard agreement under which most of derivatives transactions are documented presumes arm's-length transactions, therefore, if this definition were enacted, all existing and future pre-hedging and their related transactions may need to be redocumented. We note that ISDA had recently updated its standard Dodd Frank disclosures to address "pre-hedging."[9]

Further, prong (ii) conditions that the pre-hedging trade would occur before "the client . . . has agreed on the terms of the transaction" with the dealer (the Underlying Transaction), while it should be qualified that the terms must be "material." Without this qualifier, a vast number of trades may inadvertently qualify as "pre-hedging" because dealers and their counterparties may agree and negotiate a vast number of potential transactions that may never materialize into executable trades (for example, standby hedging facilities that may be put in place before a specific deal-contingent transactions may be negotiated).

Finally, in prong (iii), the term "anticipated" should be qualified with "reasonably"—otherwise, again, any potential transaction may qualify as "pre-hedging."[10]

Defining the Practice

The Report describes "traditional" hedging as inventory risk management practice 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, the Report notes, "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."

Even though the Report correctly states that the pre-hedging practice "may reduce market risk for dealers and the market impact of trading by lengthening the hedging window, which can allow better pricing for clients"; it does not acknowledge that the dealers take on a significant risk because the Underlying Transaction with a counterparty may not materialize, and that dealers could suffer significant cost associated with unwinding such pre-hedging transactions. The Report should be more balanced and acknowledge that the dealers incur significant costs and take on significant risks to accommodate counterparties in Underlying Transactions.

The use of correct terms—that is, hedging as opposed to pre-hedging—is important because it carries legal significance. For example, in a recent enforcement action the CFTC used the terms "hedging" and "pre-hedging" interchangeably and referred to dealer's risk mitigation trades as "pre-hedging" while material terms of these trades had already been ascertained from the counterparty—that is, this practice would qualify these trades as "hedges" under IOSCO's definition.[11]

Further, the Report should discuss instances when agency transactions are used to hedge client's risk (where a fiduciary relationship is present and an intermediary is acting as an agent for its client) as well as situations when dealers act as riskless principals, or where back-to-back swaps are used and how these arrangements differ from "pre-hedging."

Addressing the Risks of Pre-Hedging

IOSCO prepared the Report with the goal of identifying and addressing several risks potentially associated with the practice of pre-hedging. Specifically, it noted:

1. Misuse of information (i.e., insider trading and misappropriation of material nonpublic information);
2. Lack of transparency (i.e., failure to provide to counterparties adequate disclosures, where required); and
3. Lack of client consent and understanding (i.e., whether the quote from the dealer may be impacted by pre-hedging and whether there are any associated benefits or disadvantages to dealer's counterparty).

Although not specifically identified, the Report also refers to possibilities of market manipulation as well as "frontrunning," each of which have been extensively enforced and litigated by the CFTC.[12] In its recent enforcement cases involving pre-hedging and hedging by SDs, where the CFTC could not allege misappropriation of material non-public information, frontrunning, or fraud and manipulation, it charged SDs with violating § 23.431 of CFTC Regulations (requiring certain disclosure of material information to swap counterparties) and § 23.433 of CFTC Regulations (requiring fair dealing).

If IOSCO's Report is finalized, it is likely that the CFTC, as an IOSCO member, will be under pressure to either amend or promulgate additional guidance on how to comply with these regulations and what the scope of the required pre-hedging disclosures should be. For example, § 23.410(c)(2) of CFTC Regulations specifically allows SD to "use material confidential information provided by or on behalf of a counterparty to the [SD] . . . if such use . . . is necessary . . . to hedge or mitigate any exposure created by such swap. . . ." This rule would directly contradict IOSCO Recommendations if they were implemented in their current form.

IOSCO's Recommendations

The Report provides Recommendations addressing the following key considerations:

1. Genuine risk management purpose,
2. Acting fairly and honestly,
3. Focus on client's benefits,
4. Market impact and integrity, and
5. Compliance and policies and procedures.

Most of IOSCO's questions for market participants are found in this section of the Report. The following considerations, however, stand out.

Genuine Risk Management Purpose

The Report notes several factors for dealers to consider, including legitimate expectation of a client transaction, available liquidity, market conditions, and proportionality.

The Report notes that dealers may use pre-hedging to "'test' market prices and liquidity by assessing market depth." This practice needs further clarification given that there are instances when "testing" the markets may inadvertently qualify as spoofing when a dealer has no intention to execute the posted bids and offers, which is a violation of CFTC Regulations.[13] The issue would arise with testing the market in reasonable anticipation of an Underlying Transaction, versus merely in response to counterparty's potential solicitation of an Underlying Transaction (with no intention of executing these bids and offers).

Proportionality of pre-hedging positions as compared to the Underlying Transactions should be considered as evidence of whether the trade is a "hedge." Lack of proportionality may be indicative of a manipulative intent of the dealer (or "frontrunning");[14] however, IOSCO and member regulators should abstain from imposing any hard thresholds because dealers usually do not hedge on a transaction-by-transaction basis and the overall pre-hedged position may significantly exceed the risk associated with the Underlying Transaction.

Further, a pre-hedge trade is not the same as a pass-through trade. This distinction, however, is not reflected in the Report.

Acting Fairly and Honestly

This Recommendation in the Report states that "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." As noted above, the dealer typically enters into pre-hedging transaction to reduce its own risk, not to benefit the client. Stating otherwise would imply a fiduciary relationship between dealers and their counterparties.

Further, even though the terms of the Underlying Transaction must certainly be disclosed by an SD, including any attendant conflicts and other material factors stated in § 23.431, and these terms and conditions must be disclosed fairly, as required by § 23.433 of CFTC Regulations, it is impractical and unnecessary to specifically "agree" with the counterparty how the SD will pre-hedge its trades, especially if pre-hedging is done on a portfolio basis and not on a one-to-one swaps basis (which essentially would require that dealers pre-hedge only on a pass-through basis where each pre-hedged swap is attributable to each prospective swap with a counterparty). Requiring such comprehensive disclosure would effectively require dealers to disclose their confidential, proprietary and commercially sensitive information.

Focus on Clients' Benefits

Dealers (e.g., SDs in the United States) enter into pre-hedging transactions as principals acting for their own account and not as agents or their counterparties' fiduciaries; accordingly, it is inappropriate to refer to counterparties in the Underlying Transactions as "clients," which, under CFTC's Regulations, presumes some form of fiduciary relationship (the CFTC defines "customer" in § 1.3 of CFTC Regulations as distinguished from someone acting for its own "proprietary account"). Also, as described above, for example, Part 23 generally and § 23.410 specifically, refers to SD's "counterparties," not "clients" or "customers."

It is true that sometimes a counterparty in an Underlying Transaction may be referred to by an SD as "client" or "customer" (e.g., in deal-contingent foreign exchange deals); however, these trades need to be analyzed on a transaction-by-transaction basis to determine if some form of fiduciary relationship is present and whether the SD has a duty to enter into risk mitigation transactions for its own account.

Given that typically the purpose of pre-hedging is to secure the necessary inventory and to reduce market risk for the dealer—not the counterparty in the Underlying Transaction—it is impossible and impractical to expect that in each instance a pre-hedging transaction will reduce dealer's counterparty's risks and result in lower prices. Further, by definition an "inventory" is something that is held, stored, or secured before the need for the "inventory" arises. If a dealer has such "inventory" before the Underlying Transaction, does this inventory in an instant become a pre-hedge and subject to a disclosure to the counterparty?

Conversely, if a dealer chooses to not enter into a pre-hedging transaction, and as a result the "client" is not offered the best possible price in the Underlying Transaction, would this conduct on its face result in some form of violation or a breach of IOSCO's Recommendations? It clearly should not because dealers do not have a duty to pre-hedge their own potential risk exposure and the focus should be on the use of confidential material market information received from the counterparties in the anticipation of a potential transaction (as is clearly spelled out in § 23.410 of CFTC Regulations) as well as the adequate disclosure of potential risks and dealer conflicts (as is provided in § 23.431 of CFTC Regulations).[15]

Market Impact and Integrity

The Report notes that dealers must be mindful of the impact of their pre-hedging activity on the markets. This is an important consideration that is generally acknowledged; all market participants should be conscious that their trading activity may have an effect of market manipulation.

Compliance Policies and Procedures

Recommendations require that dealers identify the risks of pre-hedging, describe standards of behavior, implement internal risk controls, and ensure robust information barriers, among other things. Most, if not all, of these requirements are already provided in § 23 of CFTC Regulations, and the CFTC has already sanctioned dealers in pre-hedging transactions with respect to the lack of effective information barriers.[16]

Disclosures and Consent

Several Recommendations focus on the extent of pre-hedging disclosures that must be provided to dealers' counterparties. While disclosure is an integral part of market transparency, the scope of disclosures remains uncertain and the CFTC in a series of enforcement actions has been both defining and expanding these boundaries.[17] It is likely that the CFTC and other regulators will continue to closely monitor and sanction dealers for lack of adequate disclosures until a definitive guidance is promulgated and there is sufficient clarity as to what the applicable disclosure standards are.

IOSCO and member regulators (such as CFTC), however, should not require "client consent" to dealers' pre-hedging trades because those trades are proprietary positions outside of dealers' relationships with their counterparties. Furthermore, in many instances, it would become difficult to impossible to differentiate between counterparties to the Underlying Transactions and the counterparties to the pre-hedge trades (and vice versa).

Overall, the Report is an important step toward providing greater clarify and reducing enforcement and regulatory risks to market participants. There are several significant matters, however, that require further consideration and work before these Recommendations become final to prevent potential disruptions and other negative effects on securities and derivatives markets.

Notes

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1. https://www.iosco.org/library/pubdocs/pdf/IOSCOPD778.pdf and https://www.iosco.org/news/pdf/IOSCONEWS750.pdf.

2. The Report applies to "securities and derivatives transactions on trading venues and over the counter … markets, and across a range of asset classes (e.g., equity, fixed income, currencies, and commodities)." See Report, Executive Summary at p. 5. "Commodities" are defined in § 1(a)(9) of the CEA and include a wide range of instruments that commonly serve as reference or underlying assets to a variety of derivatives products traded in the United States.

3. 7 U.S.C. § 1(a) et seq.

4. 17 C.F.R. § 1.1 et seq.

5. See Chapter 5 of the Report.

6. For example, the European Securities and Markets Authority (ESMA) defined pre-hedging without the reference to potentially unlawful activity 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." 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.

7. For example, in United States v. Bogucki, No. 18CR00021CRB (N.D. Cal. Mar. 3, 2019) the court stated: "Here, the Government has pursued a criminal prosecution on the basis of conduct that violated no clear rule or regulation, was not prohibited by the agreements between the parties, and indeed was consistent with the parties' understanding of the arms-length relationship in which they operated. The Court cannot permit this case to go to a jury trial on such basis."

8. See, e.g., https://www.cftc.gov/media/8501/enfmizuhocapitalorder042523/download.

9. https://www.cadwalader.com/fin-news/index.php?nid=89&eid=701.

10. As further explained in the Report, once a dealer-counterparty transaction becomes irrevocable and executed, dealer's risk mitigation becomes "hedging," not "pre-hedging." See, e.g., Section 9(e)(ii) of the 2002 ISDA Master Agreement stating: "The parties intend that they are legally bound by the terms of each Transaction from the moment they agree to those terms." Also, under Part 43 and 45 of CFTC regulations, these transactions would become reportable, while mere receipt of information from the counterparty does not make that trade reportable under the CEA and CFTC Regulations.

11. See, e.g., https://www.cftc.gov/PressRoom/PressReleases/8695-23.

12. https://www.cadwalader.com/fin-news/index.php?nid=61&eid=492.

13. See, e.g., https://www.cftc.gov/PressRoom/PressReleases/8702-23.

14. See, e.g., United States v. HSBC Holdings Plc, No. 1:18cr00030 (E.D.N.Y. filed Jan. 18, 2018), ECF No. 32 and United States v. Johnson, 2017 WL 5125770 (E.D.N.Y. Sept. 21, 2017)) (the Johnson Decision). (In both proceedings, the government alleged that defendants violated federal wire fraud statutes in furtherance of front-running schemes.)

15. As noted above, in recent enforcement action relating to dealer "pre-hedging" and "hedging," CFTC's focus was not on whether a dealer could pre-hedge, but on the adequacy of disclosures. In contrast, in the Johnson case, enforcement was also not focused on whether the dealer could "pre-hedge," but on the impact of their "pre-hedging" activity that detrimentally impacted dealer's counterparties' transaction prices.

16. See, e.g., https://www.cftc.gov/PressRoom/PressReleases/8501-22.

17. See, e.g., https://www.cftc.gov/PressRoom/PressReleases/8695-23.