20 February 2025

IOSCO by On-line submission

Consultation Questions Responses

General drafting

AFMA's general points on the drafting of the Recommendations are as follows:

- Given the diverse nature of market dynamics and liquidity, asset classes, execution methods and investor sophistication around the globe, we believe IOSCO should provide high-level principles only and allow firms to tailor their internal procedures accordingly. Principle based recommendations will also make it easier to implement/consider across asset classes e.g. equity in contrast to OTC markets which are structurally different markets.
- Overlap and conflict with existing codes and practices (including the FX Global Code) should be avoided.
- IOSCO notes that existing industry codes and standards "may apply inconsistently". The word 'apply' is not correct when discussing industry codes. These codes and standards are the basis for pre-hedging practices based on actual market needs to guide consistent industry practice. Firms should be able to decide based on a risk-based approach whether any flows or order types should conform to the guidance. This may be warranted where market participants reasonably assume pre-hedging will occur.
- Dealers should have flexibility to pre-hedge up to the full risk and even where there is anticipated to be sufficient liquidity.
- Dealers should not be subject to recordkeeping requirements that would mean tagging of pre-hedging activities.
- IOSCO should consider embedding proportionality as an overarching principle for implementation of the recommendations. How a liquidity provider implements the recommendations should depend on factors such as the nature of the market, the size and complexity of the transaction, among others.

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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?

AFMA does not think the definition is satisfactory and needs changes.

While we agree that the definition of pre-hedging should include the notion that pre-hedging should be done with the intention to benefit client/s, this is distinct to an obligation to necessarily provide a benefit in all circumstances. The key word is "intention", while the intention is there it is not always possible due to market conditions for a beneficial outcome to be the result. By including this requirement as a definitional feature, this draws a clear line between activities that are in line with appropriate and effective risk management (i.e. pre-hedging) and potential market abuse (where activities have the intent to cause client detriment).

IOSCO should make clear that the use of the term client is not intended to imply any fiduciary relationships or duties.

Further clarification should be provided on how "agreed on the terms of the transaction" in paragraph (ii) of the definition of pre-hedging should be applied. For example, if the parties have agreed on the methodology for determining, all material economic terms of a transaction, will this be considered as the parties having "agreed on the terms of the transaction"?

The inclusion of *"in compliance with applicable laws and rules, including those governing frontrunning, trading on material non-public information/insider dealing, and/or manipulative trading"* in the definition is unnecessary and redundant. Removing this would be consistent with ESMA's definition as well as the FX Global Code. The presumption should be that if dealers are acting in accordance with the pre-hedging rules (as recommended by IOSCO and implemented by local regulators), the dealer will be in compliance with the referenced laws. If activity is in violation of those rules, it is clearly impermissible. IOSCO should be helping to define what is permissible outside of those rules. Reference to "frontrunning, trading on material non-public information/insider dealing, and/or manipulative trading" is unhelpful, circular and are consequently redundant and confusing. These should be deleted.

The objective for the definition is to delineate universal minimum "principles based" parameters of acceptable practices that should not offend any frontrunning/insider dealing and/or manipulative trading laws (in the context of acceptable ed pre-hedging practices) globally.

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

Inventory management

The IOSCO paper distinguishes inventory management from pre-hedging as there seems to be the implication that the practice of "Inventory management" is a form of pre-hedging. However, the schematic on page 24 has "Inventory Management" before "Pre-Hedging". "Inventory management" should be clearly distinguished from specific transaction pre-hedging. Indicators are:

- trading activity based on aggregated price request information and the dealers own independent predictions of inventory demand and
- trading activity in response to an inquiry from an individual client in respect of a specific material transaction (or group of transactions).

Accordingly, IOSCO should clarify that the definition of and recommendations for pre-hedging do not apply to inventory risk management.

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?

AFMA supports the FMSB formulation that *"Pre-hedging should be reasonable relative to the size and nature of the anticipated transaction taking into account the prevailing market conditions"* as the guiding principle. AFMA is of the view that Recommendations A1 does not need the inclusion of the term 'genuine' as pre-hedging undertaken for risk management purposes should be sufficient and does not require discussing possible cases of 'non-genuine risk management'.

IOSCO's report did not include consideration on the impact of client actions as a key factor in dealers risk management decisions. Clients may share information about potential transactions with multiple dealers, putting them in competition (such as competitive one-way RFQs). As cited in the FMSB Pre-hedging Case Studies – "*There may be greater risk of both information leakage and price slippage when a buy-side participant requests quotes from more LPs as more market participants are privy to the information"*. If clients create an expectation for a number of dealers that they each have a realistic expectation of winning a trade – this informs dealer behaviour. Multiple dealers may develop a realistic expectation of winning the same trade and take pre-emptive steps to manage the resulting risk (such as pre-hedging). These dealers expect to win the trade and are trying to act in the client's best interests, ensure available liquidity and minimize impact of market shocks by pre-hedging – however, the collective impact of these actions by multiple dealers could lead to an overall negative impact on slippage. In this situation, dealers may also be accused of front running. As a result, it is important to consider the contribution of client actions towards a dealer's risk management expectations.

The IOSCO criteria are not exhaustive and should not be applied in a cumulative fashion. Other considerations set out in the FMSB Standard for example may be relevant. The IOSCO criteria should not be considered as exhaustive. Different risk management considerations and strategies may apply depending on many factors which can differ depending on the asset class, business sector, risk profile, risk appetite, accounting practices and commercial activities of the entities involved and that of their

groups. Certain jurisdictions, such as the UK and EU, have defined the concept of risk management for particular asset classes and this should not cut across any such concepts.

Available Liquidity

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

Yes, as even where there is sufficient liquidity, pre-hedging could result in improved risk management by the dealer. For example, a trading desk may operate many hundreds of orders and activities a day so just because liquidity is sufficient for a single potential counterparty order does not make this sufficient overall. Also, liquidity changes over time and there is no certainty of liquidity at a future point in time.

The classification of a given market as "liquid" or "illiquid" can be challenging; the liquidity levels of certain markets and products can vary from month-to-month, day-to-day (including at different times during a month), and intraday in some cases. Liquidity levels can also be affected by both market-specific and external factors such as world events. It is not possible to know in advance of the execution of the transaction what liquidity will be available in the market at any given point in time as this will be dependent on the prevailing market conditions.

Furthermore, the measures of liquidity may vary according to the nature of the market. For example, measures of liquidity in OTC derivatives fundamentally differs from measures in securities; liquidity in securities may be assessed comparing trading volumes to the number 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 decentralised actors' willingness to offer hedging opportunities for certain risks.

At a practical level, past indicators of available liquidity in the market for a particular instrument are no guarantee that the same levels of liquidity can be available for that underlying instrument in the future.

Using "sufficient liquidity" as a determinant could be problematic as liquidity depends on product and market conditions at the time which fluctuate, and it may not be possible to know in advance what these liquidity levels will be.

The FMSB Spotlight Review on Pre-hedging (July 2024) has noted that *"Any distinction between the treatment of pre-hedging in liquid versus illiquid markets faces definitional challenges with quantitative, cross-asset class thresholds being difficult to determine."*

IOSCO has suggested available liquidity and market conditions as factors that should be considered in determining whether there is a genuine risk management purpose. Liquid markets may still be vulnerable to market events and resulting volatility. Pre-hedging can still benefit the counterparty in a liquid market by removing the risk arising from market volatility. Therefore, pre-hedging should be acceptable even where there is sufficient perceived liquidity.

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

In a principal market, a dealer may be handling multiple requests and orders of different sizes and seek to manage this risk in aggregate. Additionally, the variability in market characteristics around the world result in it being difficult to reliably determine "small trade sizes" and "liquid markets" in all jurisdictions, asset classes and market conditions for cross-asset class purposes and for multiple geographic regions. This is another point made in the FMSB Spotlight Review on Pre-hedging (July 2024).

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?

Principal market makers deal at arms-length, acting on their own behalf as counterparties to their clients. Dealers typically run an inventory of securities and derivatives to support their market making efforts. At any time, a dealer may be engaged in transactions with a large number of different counterparties. Consequently, they are active in managing this inventory at all given times. Where a dealer holds inventory in principal markets, that inventory may be held for its other market making activities for other clients or as hedges to that market making activity. As such, dealers should not be mandated to use their inventory in any particular way. Dealers will have different trading book structures for different desks and purposes.

IOSCO should consider that pre-hedging windows can be overlapping or run at the same time or be on a portfolio basis.

The suggestion to first fill a client's order from existing inventory may conflict with prudential risk management obligations of a regulated firm (e.g. if the existing inventory is held for risk management or liquidity purposes) or allow a firm to maintain inventory to support its entire client base (e.g. as supported by the RENTD concept in the Volcker rule).

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.

Dealers may take into account a range of factors in determining the strategy for executing a large transaction and may use different instruments to achieve this. These include asset class characteristics,

market dynamics/liquidity, and aggregate principal dealer risk management needs. It is not appropriate to specify an upper limit on the pre-hedging amount, as asset class characteristics, market dynamics/liquidity, and risk management needs might impact any decision related to how much a liquidity provider chooses to pre-hedge.

AFMA supports the FMSB formulation that pre-hedging should be reasonable relative to the size and nature of the anticipated transaction taking into account the prevailing market conditions. It would not appropriate to specify an upper limit or relative proportion on the pre-hedging amount. While pre-hedging should be permitted able to go up to a maximum of 100% of notional or anticipated risk (where it is a single transaction), it may not be possible to set the upper limit for the pre-hedging amount at 100% of the notional amount of the anticipated counterparty transaction, as dealers may enter into transaction specific and overall portfolio hedging at the same time depending on asset class characteristics, market dynamics, liquidity and risk management requirements.

Client Benefit

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

Pre-hedging with the intention to benefit the client is an objective but it is not possible definitively prove that the outcome of every individual pre-hedged trade is the best possible outcome for the client, which is recognised by IOSCO whin it says *"it may not always be possible for dealers to ensure pre-hedging does not result in market movements"* and that *"(the recommendation that dealers pre-hedge with intent to benefit the counterparty) does not mean that every individual pre-hedging trade guarantees the best possible outcome for the counterparty"*.

Client benefit needs to be understood more broadly rather than be limited to pricing alone. The general approach outlined in industry codes is that pre-hedging is a risk management tool and the concept should be framed in terms of pre-hedging not being deliberately detrimental to the client. A too narrow construction of "client benefit" leads to the risk that the broader range of benefits that the FMSB Standard and the ESMA Report have recognised will not be included.

AFMA notes the point that the FMSB made in section 4.4 of their Report where in discussing where pre-hedging is designed to benefit the client they say: *"This Principle does not require the direct pass-through of any financial benefits derived from pre-hedging by the dealer to the client."*

The benefit to the client can take multiple forms and is not limited to spread or revenue-based measures, for example regarding the speed of execution, trade size, market impact and liquidity provision. Pre-hedging can also be used for risk-management by the dealer, for the ultimate goal of benefitting the client, for example by facilitating liquidity provision or smoother execution. In other words, the benefit to the client cannot be measured based on bid-offer or direct revenue benefit alone.

IOSCO should also recognise that available liquidity and prevailing market conditions may impact the dealer's ability to deliver an outcome that does not move prices against a client's interest. Adverse price

movements may be the culmination of a range of factors, many of which are not within the control of the dealer. A dealer cannot guarantee the outcome of pre-hedging for a client or that there will be no adverse price movements. The cause of market movements is often difficult to determine due to the nature of OTC markets and actions of other participants.

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.

The financial benefit is not calculable as there is no counterfactual to compare it to and pre-hedging could be done on a portfolio basis. As discussed above, it is impracticable to reliably and specifically quantify the “financial benefit” associated with pre-hedging.

It also needs to be borne in mind that it is the liquidity provider who is bearing the risk and it is possible a loss may result instead. In addition, based on the premise of the question, should the client share a proportion of the any loss? In agreeing to execute a transaction with a client, a dealer takes on the risk that financial detriment/financial benefit may accrue from the execution of a transaction. If financial benefit is to be shared with the client, then one should expect that the risk of financial detriment should also be shared with the client. IOSCO should note that if the anticipated transaction does not materialise, none of the costs of unwinding pre-hedging is passed to counterparties.

It is also not realistic to prescribe the proportion of the financial benefit that should be shared with the client given that each dealer will have different risk, funding, liquidity, and capital requirements.

Viewing this solely in terms of pricing improvement for the counterparty is too limited and fails to take into account other aspects of the important role pre-hedging plays in facilitating counterparty trading activity via proper risk management and protecting market integrity. A counterparty may see a price benefit, but this is not the only way of considering whether pre-hedging has been a useful tool in facilitating counterparty trading activity.

Account should also be taken that a counterparty could be unwilling to take on the execution risk of a large transaction and the dealer may need to enter into pre-hedging to help facilitate the execution of a large transaction.

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?

It flows from the points made above the achieving a positive result for the client is not assured and should not be a requirement. While the intention of any dealer conducting pre-hedging should be to benefit the client in executing an anticipated order, there is no guarantee that it will always result in a trade, or a

trade at a price beneficial to the counterparty despite the intention being there. Similarly, it is not possible to provide an assurance that there will be no detriment despite the intention to benefit the client given broader OTC market conditions may unfavourably affect the outcome.

Benefit to client should be assessed more broadly than offering better pricing and should encompass other benefits such as facilitating client transaction, ensuring the effective provision of liquidity to fulfil client transactions, and/or improving the quality of execution of associated client transactions (which are examples cited in FMSB Standard).

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?

Dealers should be able to explain qualitatively why they think any particular pre-hedging has taken into account minimising market impact, such as factors that have been considered, but quantitative demonstration would be impracticable. Demonstrating the "actions taken… to minimise the market impact" is necessarily subjective, as the counterfactual (i.e., how the market would have behaved without pre-hedging) is uncertain. The focus should be on having the right policies and procedures in place rather than prescriptive documentation requirements. Practices may vary depending on the size and complexity of the transaction and the nature of the market.

We are discussing pre-hedging in principal markets, in these markets it is not common practice to cease market making for other clients and related hedging. Accordingly, firms are unlikely to isolate pre-hedging activity.

As noted above a dealer may have the intent to minimise market impact in executing pre-hedging, the outcome will be subject to prevailing market conditions that a dealer cannot control. It may be difficult to prove that the actions taken by a dealer resulted in minimal market impact if the prevailing market conditions lead to a different outcome.

In wholesale / professional markets, investors monitor execution quality and outcomes. In the case of a counterparty being dissatisfied, they can/will raise it with Sales/Trading resulting in complaint protocols being triggered.

In addition, if the proposed transaction does not progress and the dealer has entered into pre-hedging which needs to be unwound, the dealer should have the discretion to determine how the unwind should be done as the unwind could occur at a time when the relevant markets are volatile, illiquid or not functioning in accordance with normal market conditions.

Policies and procedures

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

It is normal practice for dealers to have policies on pre-hedging, but wide discretion should be afforded to dealers in terms of what the policies and procedures should cover in their overall context of the nature of their firm, the jurisdictions and markets they interact with and complying with many related requirements.

Many of the seven policies and procedures align with general industry practices (often manifested in the industry codes). However, certain elements (e.g. monitoring of trading activities or counterparty complaints) are not only of relevance for pre-hedging. Dealers should have global market manipulation policies, anti- front-running, conduct policies and global confidential and non-public information policies, including prohibitions for certain activities, in place and should communicate these to counterparties. It is unnecessary for firms to have similar or duplicative functions installed solely for the purpose of pre-hedging transactions.

Disclosure

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

Upfront, relationship disclosures that outline the role of the dealer in relevant markets, circumstances in which they may decide to pre-hedge, and that are applicable overall to transactions between them are most effective for clients. Such upfront disclosure should be sufficient for counterparties to understand their practices and make an informed decision on whether to deal with them. The relevant organisations transacting with market makers are large corporate and institutional counterparties that are sophisticated and may frequently transact with the same dealer. As such, prescribing more frequent or detailed disclosures may be of little additional value.

A dealer may determine that a transaction-specific disclosure would be beneficial for specific transactions. With respect to large transactions, FMSB guidance on trade-by-trade disclosure for bi-lateral negotiated Large Trades is generally accepted.

Upfront disclosure

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

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

To address the point related to "client sophistication" in this question, it is key to note that clients of principal dealers and market makers are typically large institutional and corporate counterparties, rather than retail clients.

The appropriate type of pre-trade disclosures will be dependent on the specific nature of the market, client relationships and transaction type. The specific content of any disclosures should be left for market participants to determine and in accordance with applicable industry standards such as the specific guidance in the FX Global Code and Global Precious Metals code.

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.

Upfront disclosure should cover the principal role of the dealer they are pre-hedging as part of their overall risk management practices, and potential impacts on the client trade. However, this content should be suitably high level, since different counterparty types and markets may require different content, for example a client with a need to transact in commodity markets in Singapore may require different information to a counterparty in Europe managing FX risks. In light of the cross-asset, cross-jurisdiction nature of pre-hedging and IOSCO's intention to provide guidance, we urge IOSCO to ensure that any future guidance is sufficiently high-level and compatible with the application of the various industry codes. Industry codes are tailored towards specific asset classes, whilst also being applicable to other asset classes (such as the FX Global Code), and may provide a more meaningful framework for counterparties depending on the markets they act in.

In addition, it should be clear from the upfront disclosure a dealer acts as principal and may conduct for itself, including its market making activities, and with other counterparties. The counterparty is then on notice and can decide whether it wants to deal on those terms of business.

Upfront online disclosures that state whether firms undertake pre-hedging in relation to competitive RFQs on electronic trading platforms may assist clients in making informed decisions about which providers to use and the basis upon which the services are being provided.

Trade-by-trade disclosure

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

Whether to provide trade-by-trade disclosure and the content of any disclosures should be left to the discretion of the dealer based on relevant factors, including their relationship with the counterparty, size of the trade, liquidity conditions, how frequently the counterparty makes similar requests, etc. Given the impact of all these factors, imposing uniform disclosure content requirements based on size or complexity thresholds is not practicable. A more "principles based" approach to the content of client communication rather than a prescriptive list-based "one-size fits all" approach would be preferable. Reasons for this include in cases of flow transactions, transactions executed over exchanges or platforms, or transactions which are subject to immediate execution.

AFMA supports the FMSB formulation - *"For transactions executed through electronic platforms, transaction-specific communications will typically not be practicable. LPs instead implement periodic, ex ante disclosures."*

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.

Trade-by-trade disclosure (described in the consultation paper as "whereby a dealer discloses its intention to pre-hedge ahead of a specific anticipated transaction") is not practical or meaningful in all markets/transactions. Again, this should be subject to the dealer's determination.

Timing can be a challenge to providing trade-specific disclosure, as trading happens rapidly and may not leave sufficient time for a client to receive and consider a pre-trade trade-specific disclosure. Any delay can have a detrimental impact on pricing and execution.

In addition, requirements for detailed trade-by-trade disclosures may require dealers to disclose confidential, proprietary and commercially sensitive information related to their hedging strategies.

For orders where competitive RFQs are placed in a fast-paced environment such as FX, trade- by-trade disclosure may not be practicable given orders are executed in milliseconds.

Post-trade disclosure

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

Post-trade disclosures should not be subject to prescriptive standards. The nature of the appropriate disclosure will depend on the transaction, market, asset class and client.

Ex-post analysis of pre-hedging practices poses significant challenges from an operational perspective as well as given the difficulties of identifying a counterfactual (i.e., what would have happened should the dealer not pre-hedge), and the inability to reliably and definitively identify precise impacts of transactions in the wider market.

In addition, sharing details of pre-hedging as part of post trade review would violate confidential information of other clients, as well as the dealers proprietary risk management and trading positions.

In some cases, post-trade disclosures could bring risks related to sharing sensitive risk management information with clients, which they could use to infer the liquidity provider's risk positions.

AFMA supports the FMSB formulation: *"In the case of a large trade, if reasonably requested by a client, and subject to appropriate confidentiality and information handling restrictions, liquidity providers should provide the client with information on the pre-hedging activity undertaken and, where possible, the general observed impact of such pre-hedging activity on the client execution".*

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?

Post-trade disclosures should not be subject to prescriptive standards. The nature of any disclosure will depend on the transaction, market, asset class and client relationship.

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.

Our response to Question 17 sets out significant barriers to the ability to provide accurate post-trade disclosures. These apply to all transaction types and channels – specifically, it would be impractical to introduce this expectation on RFQs and electronic trading platforms. The necessity for additional steps in the negotiation process will likely impact pricing and execution services available to counterparties – with

particular impact on electronic trading due to the potential to create latency this process which is particularly time sensitive.

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.

AFMA primarily consider pre-hedging as a risk management practice, with any form of consent not interfering with risk management of inventory risks. Counterparties should be able to opt-out of having the dealer engage in pre-hedging. If a dealer pre-hedges in these instances, this would be an explicit breach of the contractual terms agreed and subject to possible legal consequences. Additionally, there are alternative dealing protocols available if the client or counterparty does not want their dealer to pre-hedge (i.e. deal on an order or instruction basis instead of RFQ, market price instead of a risk transfer price).

With respect to RFQs a counterparty could be given a choice between quotes with/without pre-hedging in certain markets, this would not be feasible in all markets – e.g., latency sensitive markets – and thus should not be a mandatory requirement but remain in the discretion of the RFQ provider. It could also entail an excessive administrative burden resulting from the need to differentiate between clients allowing pre-hedging and those which do not.

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

No, setting specific requirements for explicit prior consent to pre-hedge for each transaction is not practicable given the nature of the markets and transactions involved. Upfront, relationship disclosure should be sufficient, and trade by trade prior consent should not be required. Disclosure by the dealer without objection being raised by the client should amount to negative consent. Any particular client can negotiate any bilateral arrangement with dealers in particular cases prior to trading with such dealers.

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 have existing trade surveillance processes for front running and information barrier compliance. Requiring a separate, standalone review for pre-hedging does not appear to add additional value.

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

Counterparty requests should be handled in response to their needs as it is the prerogative of the client to decide if they want any.

Post-trade reviews can be conducted where this is agreed at the outset with counterparties for large transactions. A counterparty should understand that dealers will retain the discretion to put together the content of such reviews given that not all information that is available internally may be shared with the counterparty in all cases.

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?

Dealers do not cease their principal market making and related hedging activity for other client when they engage in pre-hedging and this pre-hedging activity may be inextricably linked to such other activity, particularly when a dealer is hedging its risk at a portfolio level.

This is a practical challenge, as trading activities may be done on a portfolio basis. Given how hedging works, this would only be possible on a post-hoc basis. This capability does not exist currently, and implementing such a system would be very difficult, particularly given that it may not always be possible to identify a particular trade as pre-hedging a specific trade or macro hedging. For example, risk management may involve hedging activities in respect of anticipated demand on a portfolio basis, or in respect of a counterparty trade that ends up trading away, and risk arising from a counterparty trade may be hedged using internal inventory that is obtained in a variety of ways. Knowing how each part of the risk of a specific client trade gets covered, and from what sources, is very complicated and would require considerable resources.

It should also be borne in mind that dealers are already subject to extensive reporting and recording keeping obligations under existing regulations. These do not require the identification and recording of pre-hedging trades separately. The creation of a new requirement to do so on a standalone basis would be disproportionate in terms of costs and time, for the reasons given above, where data on such trades is

already available, and where such standalone recording would not bring any additional benefits in terms of trades surveillance and monitoring.

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?

Dealers are already subject to recordkeeping requirements that allow for a reconstruction of events if required. Trading activity and communications are recorded and can be reviewed. Current requirements are sufficient.

Firms are currently required to keep records of transactions which are executed. 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. Specifics of record keeping will vary depending on nature of the market/transaction/activity etc.

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. The FMSB, GFXC and LBMA markets have published already frameworks that address these issues. IOSCO should harmonise with these existing frameworks as much as possible as many dealers have already implemented and are operating in compliance with these frameworks today. These set out a constructive and principles-based approach to the key topics set out by IOSCO in its questions. For example, more than 1300 institutions globally have provided statements of commitment to the FX Global Code, and 190 have signed up to the Precious Metals Code. At least 12 central banks are also signatories to the FX Global Code and consider adherence to the FX Global Code in particular a pre-requisite for participation in their FX Committees. AFMA strongly encourages IOSCO to reflect upon the benefits of the existing industry-led approach for large transactions and to ensure that any additional measures that may be proposed are aligned with existing practices that have developed as a result.