

# IOSCO Consultation on Pre-Hedging

NZFMA SUBMISSION

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## Consultation Questions

1.	<p>a. Do you agree that this (see below) is the correct definition of pre-hedging?</p> <p>b. If not, how would you define pre-hedging?</p> <p>c. Does the definition of pre-hedging clearly differentiate it from inventory management and hedging?</p>	<p>a. No, NZFMA does <b>not</b> agree that IOSCO proposed definition is the correct definition of pre-hedging.</p> <p>b. NZFMA supports paragraph (i) and (iii) in the IOSCO proposed definition of pre-hedging, however NZFMA has the following suggestions on paragraph (ii).</p> <p>NZFMA believes that the phrase '<i>...anticipated client transaction</i>' encompasses a wide and potentially unmanageable range of scenarios in which conflict with the client has not yet materialised.</p> <p>NZFMA suggests that the IOSCO pre-hedging definition should clarify the meaning of '<i>anticipated client transaction</i>' with wording such as:</p> <ul style="list-style-type: none"> <li>• '<i>a future transaction that the dealer knows with certainty will proceed, but the order has not yet been placed by the client</i>', or</li> <li>• '<i>a firm client order that has been accepted by the dealer, but the price has not yet been agreed or otherwise set</i>'.</li> </ul> <p>NZFMA also suggest that the definition should include an additional paragraph detailing what is <b>not</b> pre-hedging. This additional leg of the definition should:</p> <ul style="list-style-type: none"> <li>• clarify the distinction between 'frontrunning', 'insider dealing' and 'pre-hedging' (potentially as per Financial Markets Standards Board (FMSB) pre-hedging case studies).</li> </ul> <p>c. No, NZFMA believes the definition of pre-hedging does <b>not</b> clearly differentiate it from inventory management and hedging.</p>
2.	<p>a. Do you agree with the proposed types of genuine risk management?</p> <p>b. Are there other factors not mentioned in this report that should be considered for determining genuine risk management?</p>	<p>a. Yes, NZFMA generally agrees with the proposed types of genuine risk management. However, we note:</p> <ul style="list-style-type: none"> <li>• pre-hedging to a level exceeding the risk associated with the anticipated transaction does not constitute genuine risk management.</li> </ul> <p>b. Yes, NZFMA believes that:</p> <ul style="list-style-type: none"> <li>• establishing an open risk position prior to or during pre-hedging with the intent to profit from the post-trade outcome of the pre-hedging process should be prohibited. This practice could incentivise a dealer to act in a way that results in an unfavourable outcome for the client.</li> </ul>

3.	<p>a. 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?</p> <p>b. Please elaborate.</p>	<p>a. Yes, NZFMA agrees 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.</p> <p>b. No comment.</p>
4.	Can there be a genuine need to pre-hedge small trade sizes in liquid markets for risk management purposes?	No comment.
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?	NZFMA believes a dealer should not be obligated to adjust its existing portfolio to fulfil a client order, though they may choose to do so. Additionally, dealers should be allowed to pre-hedge, even when holding inventory, provided they do so with the intent to benefit the client and minimise market impact, which can be achieved through the strategic use of inventory.
6.	<p>a. What factors should dealers consider in determining the size of pre-hedging an anticipated client transaction (e.g., size, instrument type, quotation environment)?</p> <p>b. Should there be an upper limit for the pre-hedging amount?</p> <p>c. If so, what type of limits (e.g., percentage based, Greek based) are appropriate for consideration?</p> <p>d. Please elaborate your response in relation to bilateral OTC transactions and for competitive RFQ systems including those in electronic platforms.</p>	<p>a. NZFMA believes that dealers should consider factors such as:</p> <ul style="list-style-type: none"> <li>the pre-hedging agreements/disclosures it has with the client,</li> <li>likely outcome for the client, and</li> <li>the likely impact on the market, including by considering: <ul style="list-style-type: none"> <li>Size (overall transaction, not just individual orders),</li> <li>Market environment/liquidity, and</li> <li>Instrument type.</li> </ul> </li> </ul> <p>b. Yes, there should be an upper limit for the pre-hedging amount that risk management is not more than 100% of the associated risk from the anticipated transaction, except where correlated instrument may need to be more than 100% to effectively mitigate anticipated transaction risk.</p> <p>c. Percentage based (not more than 100% of the associated risk from the anticipated transaction, except where correlated instrument may need to be more than 100% to effectively mitigate anticipated transaction risk).</p> <p>d. NZFMA:</p> <ul style="list-style-type: none"> <li>believes that it is not clear why bilateral OTC transactions should be treated differently from other transactions, as the same considerations—such as potential conflicts of interest, liquidity, execution efficiency, and the overall benefit to the client—are applicable.</li> <li>does not consider it appropriate to pre-hedge RFQs. Pre-hedging in a live, competitive RFQ environment, could result in dealers adversely affecting the price and/or liquidity of the financial instrument.</li> </ul>

<b>7.</b>	Do you agree with the concept of client benefit as described?	Yes, NZFMA agrees with the IOSCO's comments regarding an overriding obligation to treat clients fairly.
<b>8.</b>	<p>a. Do you believe that financial benefits derived from pre-hedging by the dealer should be shared with the client?</p> <p>b. What proportion of the benefit to be shared with the client would be fair?</p> <p>c. Please elaborate.</p>	<p>a. No, NZFMA believes that the financial benefits are provided to the client through reduced spread and non-financial benefits, such as those cited in the FMSB Pre-hedging Case Studies - facilitating client transactions; effective provision of liquidity; and/or improving the quality of execution.</p> <p>b. Nil</p> <p>c. NZFMA believes that:</p> <ul style="list-style-type: none"> <li>• it is unrealistic to prescribe a specific proportion of the benefit to share with the client, given varying dealer risk, funding, and capital needs,</li> <li>• the financial benefit of pre-hedging is both uncertain and difficult to quantify, as the liquidity provider bears the risk,</li> <li>• if financial benefits are shared with the client, the risk of financial detriment should also be shared, and</li> <li>• if a transaction does not occur, the costs of unwinding pre-hedging are not passed to the client.</li> </ul>
<b>9.</b>	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?	Yes, NZFMA believes the intention should be to benefit the client through both financial and non-financial factors (such as those cited in the FMSB Pre-hedging Case Studies - facilitating client transactions; effective provision of liquidity; and/or improving the quality of execution However, NZFMA notes that despite dealers' best intentions, market movements can still result in less favourable outcomes.
<b>10.</b>	<p>a. Should dealers be able to demonstrate the actions they took to minimise the market impact of their pre-hedging trading?</p> <p>b. 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?</p>	<p>a. No comment</p> <p>b. Yes, NZFMA believes that market participants, such as dealers and the institutions they represent, are subject to an ongoing requirement to maintain market integrity. The event of not entering the anticipated client transaction is no different and NZFMA believes it does not warrant special consideration in the context of pre-hedging guidelines.</p>
<b>11.</b>	<p>a. Do you agree with this recommendation on appropriate policies and procedures for pre-hedging?</p> <p>b. If not, please elaborate.</p>	<p>a. Yes, subject to NZFMA's further comments in b.below, NZFMA agrees with IOSCO recommendation that policies and procedures (similar to (i) to (vii) on page 33/34 of the IOSCO Pre-hedging Report) for pre-hedging. However, NZFMA recommends that policies and procedures be tailored to the nature of each market participants activities and context, and that IOSCO adopts a principles-based, rather than prescriptive, approach.</p>

		<p>b. NZFMA has the following recommendations regarding “appropriate policies and procedures for pre-hedging”:</p> <ul style="list-style-type: none"> <li>that IOSCO’s recommendations allow sufficient flexibility for evolving market practices and accordingly NZFMA requests that IOSCO adopts a principles-based approach that can be adapted for future technological advancements and future changes in market structure, and</li> <li>that IOSCO considers proportionality of application for smaller wholesale markets such as New Zealand. Unlike larger markets (such as the G7 markets), New Zealand has fewer liquidity providers, and market dynamics can be more sensitive to pre-hedging activities. IOSCO should recognise the risks of unintended consequences for smaller markets and allow for tailored implementation of IOSCO recommendations. For example, overly restrictive requirements on pre-hedging could discourage liquidity provision in New Zealand’s wholesale markets, and harm the ability of New Zealand financial institutions to manage risk effectively, particularly in NZD and other NZD denominated products. This could disadvantage both local and international market participants in New Zealand’s wholesale financial markets who rely on efficient execution of larger trades to support their underlying economic activity and in turn effect New Zealand’s economic performance.</li> </ul>
12.	a. What type of disclosure would be most effective for clients?	<p>a. NZFMA believes the following types of disclosure would be most effective for clients:</p> <ol style="list-style-type: none"> <li><b>Standing Disclosure (SD)</b> that outlines the pre-hedging principles, considerations, and key scenarios specific to the dealer. An SD should be either a separate disclosure or included within an order handling disclosure, rather than being part of the general terms of business or a general conflicts of interest disclosure, and/or</li> <li><b>Trade Specific Disclosure</b> for material pre-hedging transactions.</li> </ol> <p>b. NZFMA believes that effective disclosure should provide clients with the information necessary to make informed decisions about sharing information, placing orders, and choosing dealers. This disclosure must be appropriately tailored to the methods of execution and communication used in the relevant market sector, considering the client's level of sophistication.</p>
	b. Why?	
13.	a. 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?	<p>a. Yes. NZFMA believes that upfront disclosure should be provided to all customers at the outset of the relationship and via a ‘Terms of Business’ (ToB), or equivalent. A ‘ToB’ should include material including outlining the key aspects of pre-hedging for both the dealer and the client, regardless of transaction size, complexity, or client sophistication.</p> <p>b. No comment.</p>
	b. Are there any key challenges for dealers to providing pre-trade upfront disclosures?	

14.	What should be the minimum content of any upfront disclosure? Please differentiate between bilateral OTC transactions, competitive RFQs and pre-hedging in the context of electronic transactions.	No Comment.
15.	<p>a. 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?</p> <p>b. 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.</p>	<p>a. Yes, NZFMA believes that trade-by-trade disclosure should be proportional to factors such as the size and complexity of the transaction, as well as the client's level of sophistication. However, NZFMA notes that trade-by-trade disclosure for all will have an impact on speed of execution for flow type transactions.</p> <p>b. No comment.</p>
16.	<p>a. Are there any challenges or barriers to trade-by-trade disclosure in the context of competitive RFQs and in the context of electronic trading?</p> <p>b. If yes, please elaborate.</p>	<p>a. Yes.</p> <p>b. NZFMA believes that there would be unique challenges or barriers to trade-by-trade disclosure in the context of competitive RFQs and in the context of electronic trading. For example, beyond providing upfront disclosure, there maybe limited benefit from trade-by-trade disclosure for flow transactions, especially for customers that frequently transact.</p>
17.	Would clients benefit from post-trade disclosures about the dealer's pre-hedging practices in a transaction?	<p>NZFMA notes IOSCO has received feedback (pg37) that:</p> <p><i>“dealers may be performing their own commercially sensitive risk management arrangements. The pre-hedging strategy may be part of the dealer’s overall risk position management and not just that of the client’s transaction”.</i></p> <p>NZFMA agrees that post trade disclosures detailing a dealer’s pre hedging practices in a transaction can be of interest to clients. For example, a dealer could provide their clients with an overview of the outcome of material pre-hedging when requested, or in other circumstances in which the dealer/client agree are appropriate.</p> <p>NZFMA notes that where a dealer is acting in a principal capacity and incurring market risk, they should be entitled to confidentiality with respect to their trades and positions. NZFMA considers it is important to distinguish information that clients should be entitled to receive when acting as their agent, from information that relates to principal activity.</p>

<b>18.</b>	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?	NZFMA believes that post-trade disclosure should only be provided on a bilateral and case-by-case basis. NZFMA also notes that complexity of the transaction, level of client sophistication, and factors used to demonstrate that the outcome (either by quantifying or qualifying) of pre-hedging was in the “best interests” is often not practical and problematic.
<b>19.</b>	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.	No comment.
<b>20.</b>	<p>a. 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)?</p> <p>b. Are there any circumstances under which the dealer would not be obliged to follow the new client instructions?</p> <p>c. 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.</p>	<p>a. Yes, NZFMA agrees that the client should have the right 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).</p> <p>b. NZFMA believes that:</p> <ul style="list-style-type: none"> <li>there should be transparent communications with clients about pre-hedging practices generally, and with respect to material trades specifically.</li> <li>if there is a genuine business or risk management reason the dealer can’t or won’t follow those instructions, this should be disclosed to the client.</li> </ul> <p>c. No comment.</p>
<b>21.</b>	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.	Yes, NZFMA believes that consideration for explicit prior consent to pre-hedge should be determined based on materiality thresholds (e.g., size of trade is material enough to move the market), market sector, the nature of the business and the type of customer. Noting that if considered as not meeting a materiality threshold, ie considered ‘non-material pre-hedging’, it could be sufficient to provide clear, standing disclosures to clients regarding the dealer’s pre-hedging practices.
<b>22.</b>	a. Should stand-alone post-trade reviews be conducted for pre-hedging?	a. Yes, however NZFMA does not support a requirement to review all pre-hedging, in the absence of a red flag regarding conduct or outcome. NZFMA suggests that stand-alone post-trade reviews

	<p>b. How would this improve supervision of pre-hedging activities?</p> <p>c. Could this review be also used to respond to client requests for post trade review of execution practices?</p>	<p>should be considered based on a ‘materiality’ threshold (for large price sensitive transactions) and other key factors such as: market sector; the nature of the business; and the type of client.</p> <p>b. NZFMA believes that:</p> <ul style="list-style-type: none"> <li>stand-alone post-trade reviews can ensure that pre-hedging activities are undertaken within guidelines (including managing risk, limiting market impact and the intent to benefit the client) providing supervisors opportunities to assess whether relevant policies and procedures have been followed, including whether the pre-hedging was undertaken in accordance with client instructions.</li> <li>the practise of conducting post-trade reviews of material pre-hedging may act as a deterrent to poor conduct.</li> </ul> <p>c. No comment.</p>
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?	No Comment.
24.	What level of detail would be sufficient to have adequate records of pre-hedging activity to facilitate supervisory oversight, monitoring and surveillance?	<p>NZFMA believes that maintaining detailed records of orders, including timestamps, will enhance monitoring and surveillance capabilities and suggests the following be considered:</p> <ol style="list-style-type: none"> <li>for high-velocity, business-as-usual activity, supervisory oversight including communications surveillance, order management, and transaction monitoring, is sufficient.</li> <li>for large transactions, in addition to the above, specific identification and recording of pre-hedging trades should be required for effective supervisory review and deeper monitoring and surveillance.</li> </ol>
25.	<p>a. Do you believe that the industry codes already meet some or all of the recommendations?</p> <p>b. If so, please explain in detail how.</p>	<p>a. Yes, NZFMA believes that frameworks such as the Global FX Code, FMSB standards, and ASIC’s ‘Guidance for Market Intermediaries on Pre-Hedging’ all contribute positively to the discourse on acceptable pre-hedging practices.</p> <p>However, NZFMA notes that while these various frameworks address some or most of the recommendations, there remains no single framework specific to pre-hedging that is product agnostic.</p> <p>b. No further comments.</p>