CENTRE DE DROIT
BANCAIRE ET FINANCIER

Risk management

IOSCO prepares to regulate pre-hedging

Par Vaïk Müller le 29 November 2024

On 21 November 2024, the International Organisation of Securities Commissions (IOSCO) published a consultation on the practice of*pre-hedging*.

Pre-hedging* vs *front-running

Pre-hedging must be distinguished from *front-running*, which is prohibited as an unfair practice. *Front-running* consists of a financial institution executing proprietary transactions prior to a client's transactions, to the client's detriment, with a view to exploiting future price fluctuations in the client's favour.

Unlike *front-running*, *pre-hedging* enables securities firms to hedge their exposure to client orders in advance. *Pre-hedging* is a risk management tool. Despite its legitimacy *on the face of it*, *pre-hedging* raises a number of regulatory issues.

Situation in Europe and internationally

In Europe, the European Securities and Markets Authority (ESMA) conducted a public consultation on this practice between July and September 2022 to assess its admissibility under the Market Abuse Regulation (Regulation (EU) No 596/2014), the Markets in Financial Instruments Directive (Directive 2014/65/EU) and the Markets in Financial Instruments Regulation (Regulation (EU) No 600/2014).

On 12 July 2023, ESMA concluded in its final report that this practice was likely to lead to conflicts of interest or abusive behaviour but did not consider that a ban was necessary.

On 26 July 2024, the Financial Market Standards Board (FMSB) published a*spotlight review* on *pre-hedging*, containing illustrative case studies describing best practice in this area. The FMSB's examples focus on *pre-hedging* practices specific to the*fixed* income,*currencies* and ETF markets, as well as risk management activities related to new issues of interest rate*swaps*.

IOSCO definition

In its consultation , IOSCO proposes to define *pre-hedging* on the basis of the following five cumulative conditions :

1. *Pre-hedging* is implemented by a*dealer*.
2. This implementation complies with the applicable rules.
3. The securities firm executes the transactions exclusively for its own account (*principal*). If the risk is borne by the client, the *pre-hedging* operation does not follow any risk management logic.
4. Transactions are executed following prior receipt of information relating to a client transaction, but before approval or acceptance of the*quotation* by the client or its representative.
5. Transactions are executed to mitigate the risks associated with the client's (anticipated) transaction.

It is interesting to note that IOSCO's definition is largely based on that of ESMA, which was itself adopted by the FSMB. On the other hand, the notions of*benefit* to the client or facilitation of the transaction are not *strictly speaking* part of it, as these elements are dealt with in the recommendations section of the consultation.

IOSCO recommendations

On the basis of this definition, IOSCO is proposing a number of recommendations aimed at regulating *pre-hedging* transactions carried out by securities firms.

The transaction must have a recognisable risk management purpose. The securities firm must therefore take into account the predictability of the client transaction, the liquidity available, market conditions and the extent of the necessary pre-hedging in accordance with the principle of proportionality.

The securities firm must act fairly and equitably. Clients are entitled to expect transparent communication, their consent must be obtained and the information must not be used for any other purpose.

The *pre-hedging* transaction must be carried out for the benefit of the client, and the securities firm must be able to demonstrate that it has reasonably taken account of the client's instructions.

The securities firm must try to minimise the impact on the market (principle of minimisation) and ensure that the integrity of the market is maintained. In this respect, IOSCO notes that it is not always possible for securities firms to ensure that hedging of orders in advance does not generate market movements.

Implementation of risk management measures

IOSCO also intends to consult on the measures to be put in place to ensure effective risk management by securities firms. These measures concern*policies*, *compliance* processes (autonomous *post-trade* reviews), conflict of interest management and*record keeping*.

IOSCO's consultation also extends to the type, form and *timing* of communications (*upfront*, *trade by trade* or *post trade*) and client agreements. In this respect, market practice generally considers that the customer's consent is given, at least implicitly, when he accepts the commercial conditions. On the other hand, the majority of the industry considers that, in electronic *trading*, it is difficult to obtain the client's agreement for each transaction.

Conclusion

The IOSCO consultation is open until 21 February 2025. While awaiting the final report in 2025, securities firms practising *pre-hedging* should prepare to review their procedures and communications to clients, taking into account the FMSB's best practices. This preparation will enable them to anticipate the final version of the IOSCO recommendations, which can be used by national regulators, including FINMA, to shape or refine their respective practices.
