21 February 2025

International Organization of Securities Commissions

Japanese Bankers Association

Comments on the Board of the International Organization of Securities Commissions' Consultation Report: *Pre-hedging*

Dear International Organization of Securities Commissions:

The Japanese Bankers Association (JBA) appreciates the opportunity to provide our comments on the Board of the International Organization of Securities Commissions (IOSCO)'s Consultation Report on *Pre-hedging* (the "Consultation Report") released in November 2024.

General Comments

We would like to express our respect to the IOSCO's initiative to coordinate a globally agreed definition and recommendations on pre-hedging across products.

However, given that characteristics and market practices vary considerably among products, it may not necessarily be appropriate to uniformly establish the definition and recommendations. Therefore, we respectfully request that careful consideration be given in the process of coordinating the recommendations, and in developing jurisdictional laws and regulations.

Based on the thorough considerations of the issues of pre-hedging for some transactions, such as foreign exchange transactions, some internal rules with respect to pre-hedging have already been established by each firm at their discretion. Accordingly, we consider that it should be taken into account that further rules based on the proposed recommendations may impose excessive burden on market participants.

In the following, we provide our comments on each of the questions.

Comments on specific questions

<u>Chapter 5 Definition of pre-hedging</u>

> Q1:
> Do you agree that this is the correct definition of pre-hedging? If not, how would you define pre-hedging?

(Comment)

We agree with the basic concept of the IOSCO's proposed definition of pre-hedging. However, the definition should include "(pre-hedging) is a transaction executed to the benefit of the client" as defined by the European Securities and Markets Authority (ESMA) and in the FX Global Code.

Additionally, while we do not seek a uniform definition across products, we request that the definitions of "client," "irrevocably accepted an executable quote," and "inventory management" described in the diagram in page 24 of the Consultation Report be clarified to the extent possible.

<u>Chapter 6. Recommendations for Determining When Pre-hedging is Acceptable</u>

・Genuine risk management purpose

> Q2:
> 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?

(Comment)

We agree with the types of genuine risk management proposed by IOSCO. However, with respect to (b) available liquidity and (c) market conditions, it is difficult to objectively demonstrate whether there is a genuine risk management purpose because these involve dealers' subjective decision. If the proposed recommendation requires dealers to consider these factors, clear quantitative criteria should be provided.

In addition, given that some trading platforms prohibit the orders with no trading intention, we understand that there are cases where "testing actual liquidity using pre-hedging," which is one of the proposed types of genuine risk management identified in the Consultation Report, is prohibited. Therefore, we consider that there is a need to adjust the gap between the proposed recommendations in the Consultation Report and existing rules.

・1. Legitimate expectation of a client transaction & 2. Available liquidity

Q3: 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.

(Comment)

We agree with the IOSCO's view. It is difficult to reasonably assess the sufficiency of liquidity because there are some cases where pre-hedging is executed during trading hours with high liquidity while quoting is scheduled to be made during trading hours with low liquidity, and market liquidity is dependent on factors such as trading hours and market conditions of the day. Therefore, pre-hedging should be acceptable regardless of the sufficiency of market liquidity.

Q4: Can there be a genuine need to pre-hedge small trade sizes in liquid markets for risk management purposes?

(Comment)

There is a need to undertake pre-hedging described in this question. For example, in a case where volatility is high even when the market liquidity is sufficient, it is assumable that pre-hedging would be executed for a small trade size. Therefore, pre-hedging should be acceptable regardless of the market liquidity or trade size.

・3. Market conditions & 4. Proportionality in pre-hedging

Q5: 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?

(Comment)

Pre-hedging should be allowed even when a dealer holds inventory. Trading related inventory held by the dealer prior to the receipt of information about an anticipated client transaction is not subject to any operational constraints after the receipt such information. Therefore, the dealer should be allowed to determine whether to use inventory first or to execute pre-hedging at their discretion.

Q6:
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.

(Comment)

Dealers should consider in determining the size of pre-hedging including a variety of factors such as liquidity, volatility, the width of spread and the period of risk management, in addition to size, instrument types and quotation environment listed as examples.

From the amount perspective, it would be considered appropriate to set the upper limit at 100% of the client's order, in principle. However, a limit should not be set uniformly across products because product characteristics and market practices vary considerably from product to product as described in Q1, and therefore, there are diverse hedging instruments and methods.

As it is impracticable to link pre-hedging to each client's order, it may be difficult to demonstrate precisely. In addition, there are cases where pre-hedging appears to be executed for more than 100% of the client's order as illustrated below. Therefore, it is desirable that such cases should be acceptable.

(Example 1): A dealer executes pre-hedging for 100% of anticipated orders received from Company A, Company B, and Company C, which are the dealer's clients, with the same quantity (the quantity is 100 for each company) for Product A. No issue will be arisen if all transactions become agreed and/or irrevocably accepted. However, for example, if only Company C has agreed with a transaction, and the remaining transactions are failed to be agreed, the quantity of pre-hedging will be 300.

(Example 2): A dealer executes pre-hedging for 100% of anticipated orders received from Company A, Company B, and Company C, which are the dealer's clients, with the same quantity (the quantity is 100 for each company) for Product B. At the same time, the dealer also executes hedging for existing positions of Product B (the hedging quantity is 50). The amount of orders (quantity) received from the clients is 300, but, it appears that the dealer has executed pre-hedging with the total quantity of 350.

・Act fairly and honestly & To the benefit of the client

Q7: Do you agree with the concept of client benefit described above?

(Comment)

We agree with the basic concept of client benefit.

Q8: 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.

(Comment)

Financial benefits cannot be shared with the client due to the difficulty in objectively measuring financial benefits derived from pre-hedging. Even if financial benefits could be measured objectively, it would not be fair between client and dealers to share only financial benefit derived from pre-hedging and not financial losses which could be incurred through pre-hedging.

It is also difficult to set a proportion of the benefit to be shared with clients calculated based on financial benefits which are difficult to measure.

With respect to the description of 5 on page 42 of the Consultation Report, it is desirable that specific examples or best practices regarding information on how pre-hedging benefited their transaction be provided, based on practical feasibility including the difficulty in measuring financial benefits.

Q9: 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?

(Comment)

The purpose of pre-hedging should not be restricted to achieving a positive benefit for the client. For example, from the perspective of ensuring market liquidity and price adequacy, pre-hedging is always conducted with the intention of benefiting the client. However from a financial perspective, it is possible that pre-hedging may not necessarily lead to a benefit for the client. Therefore, both “to the extent that pre-hedging does not adversely affect the client” and “for risk management of the dealer” should be considered as its objective.

・Minimising market impact & Maintaining market integrity

Q10: 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 the dealer to minimise market impact and maintain market integrity prior to unwinding any pre-hedging position?

(Comment)

We believe that dealers should not be required to demonstrate the actions they took to minimise the market impact, as both pre-hedging trading and unwinding of a pre-hedged position are executed as part of a market transaction. While it is essential for dealers to fully ensure that those kinds of operations minimise the marker impact, dealers are not responsible for resulting price movements. Given that there are other market transactions, it is difficult for dealers to explain price fluctuations.

One of the actions to mitigate the market impact arising from unwinding the pre-hedged position would be to undertake pre-hedging in small lots. However, in taking this action, attention should be paid to the fact that it takes time for unwinding the position and the dealer need to take on market risk.

Chapter 7. Management of Conduct risk from Pre-hedging

・Policies and procedures

Q11: Do you agree with this recommendation on appropriate policies and procedures for pre-hedging? If not, please elaborate

(Comment)

We agree with the IOSCO’s recommendation proposing that the dealers should document and implement appropriate policies and procedures for pre-hedging.

・Disclosure and consent

Q12: What type of disclosure would be most effective for clients? Why?

(Comment)

We believe that upfront disclosure (e.g., posting of a hedging policy on the website) would be the most effective approach, as disclosure to each client would impose considerably high practical burden on dealers.

Regarding trade-by-trade disclosure and post-trade disclosure, there is room for considering disclosure, to the extent practicable, based on the nature of transaction and client attributes when there is a request from a client (e.g., disclosure of records in response to a complaint raised from a client).

・Upfront Disclosure

Q13: 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?

(Comment)

Given the size of the number of clients, transaction patterns and diversity of client attributes, it is not feasible, from a practicable perspective, to change the content of upfront disclosure according to the level of client understanding and sophistication in relation to the market. Therefore, we consider that undertaking uniform disclosure is appropriate.

Q14: 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.

(Comment)

Upfront disclosure should include, at a minimum, the content describing that the dealer may use pre-hedging, the dealer does not mean to disadvantage the client or disrupt the market, and the client has the option to determine whether or not the dealer will use pre-hedging.

We believe that the minimum content of upfront disclosure does not differ between bilateral OTC derivatives, competitive RFQs and pre-hedging in the context of electronic transactions.

・Trade by Trade Disclosure

Q15: 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.

(Comment)

We believe that trade-by-trade disclosure should be proportional to factors such as the size and complexity of the transaction and/or other factors such as level of client sophistication, but this approach is difficult to implement from a practical perspective. However, there is room for considering disclosure, to the extent practicable, based on the nature of transaction and client attributes when there is a request from a client (e.g., disclosure of records in response to a complaint raised from a client).

Q16: Are there any challenges or barriers to trade-by-trade disclosure in the context of competitive RFQs and in the context of electronic trading? Please elaborate.

(Comment)

Competitive RFQs are difficult to disclose on a trade-by-trade basis because there are not always contact points between clients and dealers. In addition, RFQs in electronic transactions are a form of transaction used in pursuit of more immediacy, and are not compatible with trade-by-trade disclosure. In particular, due to high speed and the large number of electronic foreign exchange transactions (e-FX), we are concerned that trade-by-trade disclosure is impracticable and may pose a high burden on system development.

・Post Trade Disclosure

Q17: Would clients benefit from post-trade disclosures about the dealer's pre-hedging practices in a transaction?

(Comment)

We believe that there is no benefit to clients in receiving post-trade disclosure for transactions that have already been executed and that clients do not necessarily require post-trade disclosure.

Q18: 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?

(Comment)

The nature and form of post-trade disclosure should be agreed between the client and dealer at the start of their engagement and be proportional to factors such as the size and complexity of the transaction and/or other factors such as level of client sophistication.

However, post-trade disclosure should be provided, to the extent practicable, based on the nature of transaction and client attributes when there is a request from a client (e.g., disclosure of records in response to a complaint raised from a client).

Q19: 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.

(Comment)

As described on page 37 of the Consultation Report, there are cases for which post-trade disclosure is infeasible, because it is difficult to identify which pre-hedging matches with the client's order since pre-hedging is undertaken as part of dealer's risk management.

Nonetheless, if post-trade disclosure is required, dealers need to invest a considerable amount of time and resources to fully examine the nature of pre-hedging. As a consequence, it will become difficult for dealers to respond appropriately to competitive and prompt quoting that clients truly want, giving rise to a concern that the improvement of client service will be negatively affected.

In competitive RFQs, the market impact varies depending on the number of competing financial institutions, which may make it difficult to disclose information appropriately.

・Consent

Q20:

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.

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?

(Comment)

We agree with the IOSCO's proposal 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)."

However, clients should understand that, due to their decision to not use pre-hedging, they may incur loss from the level of a quote or the market impact, or the dealer may not offer a quote if it is difficult to execute the transaction without pre-hedging.

We consider that circumstances under which the dealer would not be obliged to follow the new client instructions are unlikely to arise. However, the dealer may use pre-hedging for their own risk management purposes.

Q21:

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.

(Comment)

It is probable that, in some cases, obtaining explicit prior consent to pre-hedge will be desirable to ensure the client's understanding given the nature of the transaction. However, it is impracticable to obtain prior consent not only for certain types of transactions but also for each client or each transaction. Therefore, dealers should not be required to obtain explicit prior consent.

・Compliance and supervisory arrangements

Q22: 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?

(Comment)

The effectiveness and appropriateness of pre-hedging should be ensured by (i) understanding of the client as a liquidity consumer and (ii) persuasiveness of the dealer as a "liquidity provider." Post-trade reviews will appropriately supplement both (i) and (ii).

However, such post-trade reviews should be conducted only for individual transactions that are deemed likely to have a market impact from the perspectives of, among others, the currency, amount, and period in which pre-hedging is undertaken. Conducting post-trade reviews for all transactions is impractical given its practicability and feasibility.

A post-trade review is only a mechanism to detect misconduct within the firm. If any misconduct is detected through this review, the dealer will take appropriate actions also toward the client. Taking this into consideration, the dealer should be given discretion to determine whether to respond to the client's request and disclose the review. Further, if the dealer determines to disclose to the client that no misconduct has been identified as a result of the post-trade review, it would be appropriate to allow the dealer to simply state that: "As a result of the review, we have concluded that there was no misconduct."

・Manage information and conflicts

Q23: Do you think it is reasonable (in terms of costs and benefits) to require dealers to have internal controls to ensure differentiation between prehedging and inventory management?

(Comment)

It is not reasonable to require dealers to have such internal controls. To ensure differentiation between pre-hedging and inventory management would require the isolation of a workplace and strict portfolio segregation, which are not feasible.

For example, in foreign exchange transactions, pre-hedging is generally undertaken for inventory management and client orders without differentiation. Separating inventory management and client orders would additionally require the dealer to segregate portfolios and clarify linkage for each transaction. As a result, such internal controls will significantly increase management burden.

However, it would be useful to partially differentiate between pre-hedging and inventory management as necessary for individual transactions only if the dealer determines that they are likely to impact the market.

・Record-keeping

Q24: What level of detail would be sufficient to have adequate records of prehedging activity to facilitate supervisory oversight, monitoring and surveillance?

(Comment)

To satisfy the "sufficient" level required in the Consultation Report, we understand that information referred to in the following items (i) to (v) should be recorded or retained.

(i) Time stamp information at the time when the liquidity provider received information on an anticipated client transaction.

(ii) Time stamp and bookkeeping data at the time when the liquidity consumer agreed to the transaction's terms and conditions and/or when the liquidity consumer irrevocably accepted the executable price.

(iii) Bookkeeping data of pre-hedging activity conducted by the liquidity provider during the period between (i) and (ii), and information needed to identify the linkage between pre-hedging activity and client transactions.

(iv) Whether records of pre-hedging activity are disclosed (Currently, in the case of foreign exchange transactions, some dealers disclose such records on the website)

(v) Whether a client consent is obtained (Currently, in the case of foreign exchange transactions, some dealers disclose on the website that they make a request to client to inform them only if the clients do not want pre-hedging to take place).

However, recording and retaining the above information would pose a significant operational burden to intermediaries (sales dealers) and independent control functions. Further, we are concerned that requiring such record keeping practices for all transactions, if implemented, would incur a significant amount of costs for system development and other compliance efforts, and require a considerable preparation period. Therefore, the level of detail for record keeping practices should be determined after carefully considering feasibility; for example, require record keeping only for those foreign exchange transactions exceeding a certain amount-based threshold, or conduct monitoring based on information that is collectible in practice.

・Industry codes

Q25: Do you believe that the industry codes already meet some or all the recommendations? If so, please explain in detail how.

(Comment)

Commentary on Principle 11 and the role of pre-hedging in today's FX landscape, published by the Global Foreign Exchange Committee (GFXC) in July 2021, is a guidance prepared by the GFXC based on various views of market participants collected through its 2019 survey. This does not undermine current trading practices and meets the proposed recommendations in the Consultation Report.

(End)