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1 February 2024

Dear Chief Executive

Guidance for market intermediaries on pre-hedging

This letter sets out ASIC's guidance regarding pre-hedging practices in Australia. This aims to:

- raise and harmonise minimum standards of conduct related to pre-hedging;
- improve transparency so that clients[1] are better informed when making investment decisions;
- promote informed markets and a level playing field between market intermediaries; and
- uphold integrity and investor confidence in Australian financial markets.

We acknowledge that pre-hedging has a role in markets, including in the management of market intermediaries' risk associated with anticipated client orders and may assist in liquidity provision and execution for clients.

However, it can also create significant conflicts of interest between a client and the market intermediary which actively trades in possession of confidential information about the client's anticipated order or trade. Market intermediaries need to manage confidential client information very carefully and have robust, closely monitored and frequently tested arrangements for ensuring conflicts of interest are appropriately managed and in compliance with the *Corporations Act 2001* (Corporations Act).

We have observed a wide range of pre-hedging practices in the Australian market, with some falling significantly short of our expectations. Differences in pre-hedging practices can disrupt fair competition and the effective functioning of markets.

Raising and harmonising minimum standards of conduct is a key focus of ASIC and an increasing focus among international regulators and standard setters, including the International Organization of Securities Commissions[2] (IOSCO), the European Securities and

[1] In this letter a 'client' includes a counterparty where the intermediary, acting in a principal capacity, is conducting pre-hedging to execute a transaction with that counterparty.
[2] IOSCO has highlighted vulnerabilities in pre-hedging as an area of focus.

Markets Authority[3] (ESMA), the Financial Markets Standards Board[4] (FMSB), and the FX Global Code[5].

Our guidance for market intermediaries on pre-hedging is set out below. We may supplement this with further guidance as the international work progresses.

ASIC's guidance

In complying with obligations under the Corporations Act, including providing financial services efficiently, honestly, and fairly (section 912A), market intermediaries are required to have adequate arrangements for managing conflicts of interest and market abuse.

Market intermediaries should always carefully consider their obligations under Australian law and applicable international codes and standards when undertaking pre-hedging.

Accordingly, we anticipate market intermediaries that undertake pre-hedging will:

1. document and implement **policies and procedures** on pre-hedging to ensure compliance with the law. They should ideally be informed by consideration of the circumstances when pre-hedging may help to achieve the **best overall outcome** for clients;

2. provide effective **disclosure to clients** of the intermediary's execution and pre-hedging practices in a clear and transparent manner. Better practice includes:

    - upfront disclosure, such as listing out the types of transactions where the intermediary may seek to pre-hedge; and

    - post-trade disclosure, such as reporting to the client how the pre-hedging was executed and how it benefitted (or otherwise impacted) the client;

3. obtain explicit and informed **client consent** prior to each transaction, where practical, by setting out clear expectations for what pre-hedging is intended to achieve and potential risks such as adverse price impact. For complex and/or large transactions, the intermediary should take additional steps to educate the client about the pre-hedging rationale and strategy;

4. **monitor** execution and client outcomes and seek to **minimise market impact** from pre-hedging;

5. appropriately restrict access to, and prohibit misuse of **confidential client information** and adequately **manage conflicts of interest** arising in relation to pre-hedging. It is critical that appropriate physical and electronic controls are established, monitored, and regularly reviewed to keep pace with changes to the business risk profile;

6. have robust risk and compliance controls, including trade and communications monitoring and surveillance arrangements, to provide effective **governance and supervisory oversight** of pre-hedging activity;

7. **record** key details of pre-hedging undertaken for each transaction (including the process taken, the team members involved, and the client outcome) to enhance supervisory oversight and monitoring and surveillance; and

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[3] ESMA in July 2023 published its report on feedback to its call for evidence on pre-hedging.
[4] The FMSB has a current working group on pre-hedging and has set out pre-hedging principles in its standard for the execution of large trades in FICC markets.
[5] The FX Global Code describes market practice for dealers undertaking pre-hedging in FX markets.

8. undertake **post-trade reviews** of the quality of execution for complex and/or large transactions. This should be performed by independent and appropriately experienced supervisory team members.

If pre-hedging is not carried out in an appropriate manner it can be unfair, unconscionable and result in poor client outcomes. This may adversely impact investor confidence and undermine market integrity.

We encourage you to carefully consider the guidance set out in this letter.

Yours sincerely

Simone Constant

Commissioner