STRUCTURED
FINANCE
ASSOCIATION

February 21, 2025

Via Web: https://qualtricsxmrppp5bdgs.qualtrics.com/jfe/form/SV_3epXw2Y19hrM4HI

Re: CR/11/24
Consultation Report on Pre-Hedging

To Whom It May Concern,

By way of introduction, the Structured Finance Association ("***SFA***") appreciates this opportunity to provide feedback (this "***Comment Letter***") to the Board of the International Organization of Securities Commissions ("***IOSCO***") regarding the above-referenced consultation report (the "***Consultation Report***").

As discussed in the Consultation Report, IOSCO's aim in publishing the Consultation Report and associated request for comments is to develop a proposed definition for pre-hedging and a minimum set of recommendations as guidance for local regulators to consider in relation to when pre-hedging may be appropriate and the effective management of conduct risk arising from pre-hedging.

Pre-hedging provides legitimate benefits to the market and all market participants, and bona fide pre-hedging practice can and should be differentiated from otherwise unlawful and fraudulent practices. In other words, frontrunning, insider trading or manipulative trading are not pre-hedging.

SFA is uniquely situated to comment on the potential effects that the Consultation Report and any final report published by IOSCO ("***Final Report***") may have on the structured finance and securitization markets. As an association representing participants across the full spectrum of the structured finance and securitization markets – including lenders, dealers, securities issuers, institutional investors, financial intermediaries, credit rating agencies, law firms, accounting firms, technology firms, servicers and trustees – SFA plays a vital role in the development of market-consensus solutions that support efficient and stable markets.[1] While our members often have conflicting views and interests, our governance structure requires consensus from all stakeholder

[1] SFA is a member-based, trade industry advocacy group focused on improving and strengthening the broader structured finance and securitization market. SFA provides an inclusive network for securitization professionals to collaborate and, as industry leaders, to drive necessary changes, to be advocates for the securitization community, to share best practices and innovative ideas and to educate industry members through conferences and other programs. Further information can be found at www.structuredfinance.org.

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groups before SFA takes an advocacy position on legislative or regulatory matters. As such, when we do provide feedback to requests for comment, and we do so in a manner that reflects the views of the entire market ecosystem.

This Comment Letter is organized as responses to a set of recommendations and questions provided in the Consultation Report. From the outset, we note that these comments are provided within the jurisdictional context of market practices and the laws and applicable regulations in the United States ("***U.S.***").[2]

I. Responses to Recommendations and Consultation Questions

A. 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?*

The following changes to the definition are suggested:

"trading undertaken by a dealer, in compliance with applicable laws and rules, ~~including those governing frontrunning, trading on material non-public information/insider dealing, and/or manipulative trading:~~ where:

(i) the dealer is ~~dealing on its own account in a principal capacity~~ acting as a principal for its own account;

(ii) the trades are executed after the receipt of material information about a~~n~~ reasonably anticipated ~~client~~counterparty transaction and before the ~~client~~counterparty (or an intermediary on the ~~client~~counterparty's behalf) has agreed on the material terms of the transaction and/or irrevocably accepted an executable quote; and

(iii) the trades are executed to manage the risk related to the reasonably anticipated ~~client~~counterparty transaction."

The language referencing frontrunning, material non-public information, insider dealing and manipulative trading should be deleted because it is not appropriate to refer to the legitimate practice of pre-hedging by reference to a number of illegal and abusive practices.[3] Such references would only impose a negative connotation on pre-hedging and at the outset presume that pre-hedging is a disfavored practice.

References to "client" should be struck and replaced with "counterparty" because, in some jurisdictions (including the U.S.), the terms "client" or "customer" are statutorily defined and are

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[2] The comments herein relate primarily the U.S. Commodity Exchange Act of 1936, U.S.C. 7, § 1a, *et seq.* (the "***CEA***"), and the regulations of the U.S. Commodity Futures Trading Commission (the "***CFTC***"), 7 C.F.R., § 1, *et seq.* (the "***CFTC Regulations***"). Additionally, references herein to "dealers" refer to "swap dealers" as defined in § 1a(49) of the CEA and "security-based swap dealers" as defined in § 1a(43) of the CEA.

[3] Note that there are numerous CFTC and SEC enforcement action addressing these violations.

used in the context of intermediation and advisory services and not in the context of dealer activity (where the term "counterparty" is traditionally used). Additionally, the language "dealing on its own account in a principal capacity;" should be struck and replaced with "acting as a principal for its own account;". Specifically, in the capacity of the contemplated arms-length transactions which may be pre-hedged, the dealer acts as a principal for its own account and not as an agent for the other party to the transaction, thus the other party is not a "client" or "customer," and the dealer does not owe them a fiduciary duty.[4] Except in very limited circumstances,[5] a dealer should not be imputed to have any sort of fiduciary duty to a transaction party simply because it is facilitating a transaction, and likewise no fiduciary duty is imputed to a dealer with respect to counterparties to other types of transactions with the dealers in which there may be a conflict of interest. As long as the dealer makes proper disclosures (as discussed in further detail below), this is consistent with the FX Global Code and the Global Precious Metals Code,[6] as well as the FMSB Large Trades Standard.[7] To prevent any ambiguity, all references to a "client" in the Final Report should be corrected to refer to a "counterparty" (as is in this Comment Letter).

Furthermore, the term "customer" carries a very specific meaning under applicable U.S. law governing swap transactions of this type and has been traditionally used to refer to intermediaries' (*i.e.*, agents') customers transacting in futures contracts,[8] while the counterparties to swap transactions are typically engaging in principal-to-principal trades.[9] The CFTC Regulations[10] define a "customer" as follows:

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[4] *See, e.g.*, Financial Markets Standards Board, Standard for the execution of Large Trades in FICC

markets, *available at* https://fmsb.com/wp-content/uploads/2021/05/FMSB_Large_Trades_Standard_-FINAL-05.05.21.pdf at p. 6 ("Core Principle 2: When acting as agent, pre-hedging is never permitted in the relevant market...Pre-hedging is not permissible in a scenario where the dealer is acting as agent.") (the "***FMSB Large Trades Standard***").

[5] *See, e.g.,* provisions applicable to swap dealers transacting with counterparties that qualify as "special entities," as defined in § 23.401(c) of the CFTC Regulations.

[6] The FX Global Code defines a "Principal" as a market participant who transacts for its own account. Additionally, Principle 11 of the FX Global Code states that "a Market Participant should only Pre-Hedge Client orders when acting as a Principal...." *See* Global Foreign Exchange Committee, FX Global Code, *available at* https://www.globalfxc.org/uploads/fx_global.pdf (the "***FX Global Code***"). This is substantially similar to PTE Principle 6 of the Global Precious Metals Code, which states that "A Market Participant should only Pre-Hedge Client orders when acting as a Principal, and should do so fairly and with transparency". *See* London Bullion Market Association, Global Precious Metals Code (December 2022), *available at* https://cdn.lbma.org.uk/downloads/GPMC/Global-Precious-Metals-Code-2022.pdf (the "***Global Precious Metals Code***").

[7] *See, e.g.,* the FMSB Large Trades Standard at p. 4 ("Principals act on their own behalf and there is no obligation to execute a transaction until both parties are in agreement. Principal activity involves taking on one or more risks in connection with a transaction, including market and credit risk....An agent executes transactions on behalf of the client pursuant to the client mandate, and without taking market risk in connection with the transaction.").

[8] Note that, *e.g.*, futures commission merchants under the CFTC Regulations and as defined in the CEA (§ 1a(28)), are presumed to act as agents – unless specifically noted in limited circumstances when they act as "counterparties" only in the context of retail forex and retail commodity transactions under § 2(c)(2)(C)(i) or § 2(c)(2)(D)(i) of the CEA.

[9] *See* § 23.401 (Definitions) in the CFTC Regulations: "(a) Counterparty. The term "counterparty," as appropriate in this subpart, includes any person who is a prospective counterparty to a swap."

[10] *See* § 1.3 of the CFTC Regulations. Likewise, the term "client" is defined by the CFTC in the context of commodity trading advisors, who are fiduciaries of their advisory clients.

> *Customer.* This term means any person who uses a futures commission merchant, introducing broker, commodity trading advisor, or commodity pool operator as an agent in connection with trading in any commodity interest; *Provided, however,* an owner or holder of a proprietary account as defined in this section shall not be deemed to be a customer within the meaning of section 4d of the Act, the regulations that implement sections 4d and 4f of the Act and § 1.35, and such an owner or holder of such a proprietary account shall otherwise be deemed to be a customer within the meaning of the Act and §§ 1.37 and 1.46 and all other sections of these rules, regulations, and orders which do not implement sections 4d and 4f of the Act.

As further discussed below, this is just one of many examples where the terms and some of the concepts used in the Consultation Report may directly contradict the provisions found in applicable U.S. laws and regulations. Therefore, to the extent possible, the Final Report should be reconciled to align with the U.S. regulatory framework under the CEA and the CFTC Regulations where there is a direct conflict.

If such reconciliation is impossible due to the utilization of a uniform and multijurisdictional approach in the Consultation Report, at a minimum, the Final Report should clarify that the use of the term "client" does not imply a fiduciary relationship between the dealers (the sell-side market participants) and their "clients" (*i.e.*, the buy-side market participant counterparties) and that both types of market participants are acting on the principal-to-principal basis vis-à-vis each other with no fiduciary relationship imputed between them.

Qualifiers such as "material" should be added before "information" and "terms of the transaction" as not all information or terms of a potential transaction are relevant to or could be acted upon by a dealer to warrant any requirements that a regulator could apply to pre-hedging transactions. Additionally, the qualifier "reasonably" should be added before "anticipated [counterparty] transaction" as any requirements applicable to pre-hedging transactions should not apply to trading activities by a dealer executed with no reasonable expectation by the dealer that it would actually enter into a corresponding transaction with a counterparty with risk(s) to be hedged by such trading activities.

Lastly, others in the market have suggested that prong (iii) of the definition should reference an intent standard (*e.g.*, that the trades are intended to manage the risk of a transaction); however, an intent standard should not be used as that is too vague a standard to be helpful and may be difficult to evidence in respect of pre-hedging trades that are undertaken by a dealer on a portfolio-level basis or that coincide with a dealer's portfolio hedging or rebalancing transactions and may impose an additional obligation on dealers to "tag," match, or otherwise specifically identify each hedging and pre-hedging transaction with each counterparty trade. Furthermore, CFTC Regulations do not impose this additional "intent" standard on dealers hedging their exposure to counterparty swaps.[11]

[11] *See, e.g.*, § 23.410(c)(2)(ii) of the CFTC Regulations.

➢ ***Recommendation A1:*** *Dealers should undertake pre-hedging only for a genuine risk management purpose.*

B. 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?*

Recommendation A1 should not refer to a "genuine risk management purpose", but instead, should refer to a "risk management purpose". The inclusion of the word "genuine" imposes a vague standard and implies that parties other than the dealer could be able to determine whether a risk management purpose undertaken by the dealer was not "genuine". The focus should be on identifying a non-exhaustive list of purposes and key principles that underlie allowable risk management purposes, rather than limiting the possible universe of risk management purposes by creating a vague and arbitrary standard. It would not be practical to try to identify an exhaustive list of risk management purposes across the varying asset classes, let alone when factoring in such material considerations as market sector, portfolio composition, risk appetite, etc.

Recommendation A1 should be expanded to recognize that dealers may undertake pre-hedging to facilitate counterparty transactions in addition to risk management purposes, for example, via price discovery, as discussed further in the next paragraph. Absent a dealer's ability to engage in price discovery, the spread offered by a dealer may not be as accurate and thus not provide as low of a cost or as much certainty for a counterparty because the dealer would have to factor in the cost of its hedging risk on the back-end of the transaction.

The third prong of the discussion of "genuine risk management purposes" in the Consultation Report recognizes that "Dealers may use pre-hedging to 'test' market prices and liquidity by assessing market depth, particularly where the market for the financial instrument is characterized by low liquidity, or if the anticipated transaction is large relative to the market absorption capacity. Depending on the specific asset class and market structure, the level of 'observable' liquidity may be different to 'actual' liquidity. The ability to 'test' actual liquidity using pre-hedging can particularly benefit products traded on OTC markets, where pre-trade price transparency can be lower." This risk management purpose should be referred to as engaging in price discovery rather than "testing" market prices and liquidity. The use of the term "test" may be confusing in that pre-hedging involves the actual execution of transactions, not "tests" that are not executed.

Additionally, referring to the legitimate practice of price discovery as "testing" market prices could have negative connotations or sound like frontrunning or other manipulative activity (*e.g.*, spoofing, when a dealer has no intention to execute the posted bids and offers, which is a violation of the CFTC Regulations) rather than a transaction undertaken to benefit counterparties by attempting to uncover an accurate price in reasonable anticipation of entering into an executable transaction.

C. 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, however, it may not be feasible to rely on liquidity alone as an indicator or to define it across asset classes, as for example, in OTC derivatives markets where liquidity may not be observable absent pre-hedging, or in asset classes where liquidity levels vary on a cyclical basis.

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

As discussed above, pre-hedging should not be analyzed in terms of whether a certain aspect is "genuine". The benefit being served to liquid (and illiquid) markets with respect to pre-hedging smaller transactions is the ability of a dealer to have a longer temporal window across which to spread out market impacts and thus reduce any potential market-moving activity that could affect pricing for a counterparty. Additionally, it may not be feasible to attempt to define transaction sizes across asset classes and relative to dealer and counterparty portfolios, so transaction size should not be the measure for whether pre-hedging is appropriate.

It is also important that any activity that does move the market against a dealer's counterparty not be considered *de facto* evidence of manipulative trading by a dealer. To suggest that "pre-hedging more than the anticipated full amount of a client transaction may not meet the objective of genuine risk management and is more likely to negatively impact market integrity and result in a worse outcome for the client" does not reflect the reality that a dealer may enter into hedges on a portfolio basis rather than on a trade-by-trade basis. To require pre-hedging to be done on a trade-by-trade basis may also have the effect of moving the market against a dealer's counterparty more than it would have otherwise, or may discourage price discovery and lead to counterparties being quoted larger spreads (as discussed above in response to ***Question 2***).

D. 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?*

The proportionality of transactions compared to the underlying counterparty transaction can be useful as evidencing whether a trade is intended to be a pre-hedge of an underlying counterparty transaction, and a lack of proportionality may be indicative of a dealer's manipulative intent (*e.g.*, frontrunning). However, there may be a number of reasons that a dealer may not be able to use existing inventory as a means of offsetting risk, including, for example, if such inventory is already being used as a hedge against the dealer's existing transactions.

Additionally, dealers may not hedge on a trade-by-trade basis so a pre-hedged position may not appear to correspond to any one underlying counterparty transaction. For example, a pre-hedging transaction may represent a dealer hedging for other transactions in its portfolio simultaneously with its hedge for an underlying counterparty transaction and thus exceed the risk

associated with the single underlying transaction. The Final Report should thus avoid recommending the adoption of any hard thresholds or restrictions that are overly prescriptive.

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.*

As stated above, the Final Report should avoid recommending the adoption of any hard thresholds or restrictions that are overly prescriptive. It should be largely up to a dealer to determine appropriate pre-hedging practices based on market conditions and the composition of its own portfolio. Dealers in the same markets and who are active in market making in the same asset classes may nonetheless have significantly varying risk profiles based on their specific portfolios and trading strategies. It would not be feasible or practical to attempt to set levels that would result in equivalent outcomes for all dealers.

➢ ***Recommendation A2:*** *Dealers should (i) act fairly and honestly to clients and (ii) undertake pre-hedging only with the intention to benefit the client.*

E. Client Benefit

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

No. It is inappropriate to measure pre-hedging activity in respect of any direct "client benefit" because, as discussed above, in the context of structured finance and securitization transactions, the secondary party to a transaction is a counterparty, rather than a client or customer, thus the dealer does not owe such party a fiduciary duty. A dealer should not be imputed to have any sort of fiduciary duty to a counterparty simply because it is facilitating a transaction, nor should the dealer be required to act in the counterparty's sole or best interest, as is the case with other arms-length transactions freely entered into between market participants. It also may not be feasible in all cases to identify or quantify the direct benefit to a counterparty of a proposed transaction (whether through the price the dealer is ultimately able to provide to such counterparty or otherwise) for a myriad of reasons. For example, even in circumstances where a dealer believes it would be able to effect a pre-hedging transaction in such a way that it could provide a directly observable benefit to a counterparty (*e.g.*, via price), a dealer cannot guarantee that such benefit could come to fruition because of market movements and other external factors that may not be within dealer's control. Further, even in such circumstances, counterparties may still obtain the indirect benefits discussed in response to ***Question 2*** above (*i.e.*, transaction facilitation and price discovery, transaction speed, liquidity provision, etc.).

Instead, a better view is that a dealer should undertake pre-hedging only if it does not have the intent to disadvantage the counterparty. This is consistent with each of Principle 8 of the FX Global Code, PTE Principle 3 of the Global Precious Metals Code, and the definition of "Principal" in the FMSB Large Trades Standard, which state the following, verbatim: "Where the acceptance of an order grants the Principal executing the order some discretion, it should exercise this

discretion reasonably, fairly, and in such a way that is not designed or intended to disadvantage the client."[12]

Additionally, while dealers should not be able to make a market in products and then use market information to a counterparty's detriment, this proposition should be evaluated separately from the "client benefit" concept as prohibitions and guardrails on such manipulative behavior already exist (*e.g.*, mandated conflict of interest disclosures, insider trading and anti-fraud regulations, *etc.*) to prevent a counterparty from being misled or treated unfairly.[13] This proposition is also acknowledged in Principle 11 of the FX Global Code (*i.e.*, "A Market Participant should only Pre-Hedge Client orders when acting as a Principal, and should do so fairly and with transparency"), which ***Recommendation A2*** should be revised to track more closely.

Further, market participants are free to bilaterally negotiate additional protections for themselves (*i.e.*, when properly disclosed, a counterparty can negotiate with a dealer that it will not accept pre-hedging, or it can simply choose not to seek to enter into any trades with a dealer which has disclosed it engages in pre-hedging), so there is no compelling reason to recommend such protections be mandated at this time.[14]

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.*

No. Just as a counterparty would not be responsible for bearing any losses sustained by the dealer (whether respect to a pre-hedge or an irrevocable transaction), the dealer should not be required to share its own benefits received through its risk mitigation practices with the counterparty. Provided that a counterparty is provided transparency regarding the nature of the trading relationship, transactions with a dealer should be treated as any other arms-length transaction. Moreover, such a calculation and allocation may not be easily calculated or allocable in the first place; one of the main benefits to the counterparty may be the facilitation of the transaction via the dealer's provision of liquidity in the product.

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?*

As discussed in response to ***Question 7*** above, "client benefit" is not an appropriate measure. The standard should be that pre-hedging is acceptable where (i) a dealer pre-hedges for risk

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[12] Note that, while the FX Global Code, the Global Precious Metals Code, and the FMSB Large Trades Standard use the term "client", they do not refer to an agency relationship, as discussed further in the response to ***Question 1*** above.

[13] In fact, for example under § 180.1 of the CFTC Regulations, in the past several years the CFTC has prosecuted many entities engaged in misappropriation of material non-public information in violation of a preexisting fiduciary duty (*e.g.*, a duty between an employer dealer and its traders *see e.g.*, In the Matter of Arya Motazedi, CFTC Docket No. 16-02 (Dec. 2, 2015), *available at* https://www.cftc.gov/sites/default/files/idc/groups/public/@lrenforcementactions/documents/legalpleading/enfmotazediorder120215.pdf.

[14] A counterparty also has the ability to receive quotes from multiple dealers, thus ensuring best execution; therefore, a counterparty is not mandated to trade with that particular dealer.

management or counterparty transaction facilitation purposes, and (ii) such pre-hedging has been properly disclosed.[15] While a dealer should not engage in pre-hedging with the intent to disadvantage a counterparty, both "intent" and "disadvantage" are problematic to prove/disprove in the context of the trading relationships contemplated herein and thus should not be used as objective standards for which only directly observable effects are taken under consideration. For example, if a dealer chooses not to engage in pre-hedging, there should be no implication that failure to pre-hedge was detrimental to a counterparty transaction if the ultimate price offered to the counterparty was not the best possible price, and there should likewise not be an implied duty of "best execution" imputed to every swap transaction.

➢ ***Recommendation A3:*** *Dealers should (i) minimise market impact and (ii) maintain market integrity when pre-hedging.*

F. 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 act with the principle in mind of using commercially reasonable efforts to minimize the market impact of any pre-hedging undertaken and do their part to maintain market integrity. For example, in a competitive request for quote ("***RFQ***") situation, there may be amplified market effects if multiple dealers are engaging in pre-hedging; however, the onus should not be squarely on the dealer to manage price risk in this situation—a counterparty should be aware that prices may be driven up by dealers seeking multiple quotes. Nonetheless, an RFQ platform could disclose relevant market and price risks to market participants prior to the counterparty submitting such RFQ or could allow a counterparty to request a quote only from dealers who do not pre-hedge, at the counterparty's option, as discussed in response to ***Question 21*** below.

Further, the Consultation Report's acknowledgement that "it may not always be possible for dealers to ensure pre-hedging does not result in market movements" is significant because a dealer may not be in a position to demonstrate in every instance how it may have minimized market impact better if it engaged in pre-hedging that was otherwise permissible. Thus, the standard to evidence a dealer's wrongdoing should not be whether the dealer minimized market impact, it should be whether market integrity was compromised as a result of the dealer's pre-hedging.

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[15] We note that the CFTC in the past several years has prosecuted several dealers under § 23.431 that requires adequate disclosures of material facts to a dealer counterparty; in these enforcement actions the CFTC believed that dealers had not properly disclosed their pre-hedging practices. However, in none of these enforcement actions that CFTC alleged that the pre-hedging practice itself was inappropriate or otherwise violated § 180.1 of the CFTC Regulations or any other provision of the CEA (*see, e.g.*, In the Matter of Mizuho Capital Markets LLC, CFTC Docket No. 23-24, Apr. 25, 2023; *see also* In the Matter of ED&F Man Capital Markets, Ltd., CFTC Docket No. 22-13, Mar. 15, 2022).

➢ ***Recommendation B1:*** *The dealer should document and implement appropriate policies and procedures for pre-hedging.*

G. Policies and procedures

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

Policies and procedures required under applicable law should be aligned with existing industry practices and should not create duplicative compliance burdens with existing regulatory obligations – *i.e.*, there should not be pre-hedging-specific requirements to the extent that existing compliance obligations (*e.g.*, with respect to supervision and trade/communications monitoring) would address pre-hedging conduct. Note also that the CFTC Regulations already address this point.[16]

However, as further discussed below, ***Recommendation B3*** that a dealer should obtain prior affirmative consent from a counterparty to engage in pre-hedging is inappropriate and impractical – it should be sufficient that a dealer has clearly disclosed that it will engage in pre-hedging and the counterparty has not specifically objected.

➢ ***Recommendation B2:*** *The dealer should provide clear disclosure to clients of the dealer's pre-hedging practices.*

➢ ***Recommendation B3:*** *The dealer should obtain prior consent from the client.*

H. Disclosure

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

With respect to ***Recommendation B2***, appropriate disclosures should be provided to a dealer's counterparties, which is already specifically required by § 23.431 of the CFTC Regulations.[17]

With respect to ***Recommendation B3***, dealers should not be required to obtain prior consent from their counterparties in relation to such dealers' entry into pre-hedging transactions with unrelated third parties. Such a requirement would conflict with the provisions of § 23.410(c) of the CFTC Regulations, which provides:

> (c) *Confidential treatment of counterparty information.*
>
> (1) It shall be unlawful for any swap dealer or major swap participant to:
> (i) Disclose to any other person any material confidential information

[16] *See* § 23.410(b) of the CFTC Regulations which provides: "Affirmative defense. It shall be an affirmative defense to an alleged violation of paragraph (a)(2) or (3) of this section for failure to comply with any requirement in this subpart if a swap dealer or major swap participant establishes that the swap dealer or major swap participant: (1) Did not act intentionally or recklessly in connection with such alleged violation; and (2) Complied in good faith with written policies and procedures reasonably designed to meet the particular requirement that is the basis for the alleged violation."

[17] *See also* note 15 *infra*.

> provided by or on behalf of a counterparty to the swap dealer or major swap participant; or (ii) Use for its own purposes in any way that would tend to be materially adverse to the interests of a counterparty, any material confidential information provided by or on behalf of a counterparty to the swap dealer or major swap participant.
>
> (2) Notwithstanding paragraph (c)(1) of this section, ***a swap dealer*** or major swap participant ***may disclose or use material confidential information provided by or on behalf of a counterparty to the swap dealer*** or major swap participant ***if such disclosure or use*** is authorized in writing by the counterparty, or ***is necessary: (i) For the effective execution of any swap for or with the counterparty; (ii) To hedge or mitigate any exposure created by such swap;*** or (iii) To comply with a request of the Commission, Department of Justice, any self-regulatory organization designated by the Commission, or an applicable prudential regulator, or is otherwise required by law....

With respect what type of disclosure would be most effective for counterparties, as discussed in further detail below, a standing, general upfront disclosure that discloses potential conflicts of interest and explains principles of fair dealing is the only appropriate, practical and feasible disclosure that may be mandatory for a dealer to provide.[18] Any more comprehensive disclosure would effectively require dealers to disclose their confidential, proprietary and commercially sensitive information and present logistical and operational challenges that could hinder the provision of timely and accurate quotations to counterparties. This could be provided by a dealer in an agreement with a counterparty or through other means decided by the dealer. Further, in the context of bilateral OTC transactions, given that only sophisticated institutions (such as "eligible contract participants" in the U.S., as defined in § 1a(18) of the CEA) can be counterparties in derivatives markets, these entities should be able to adequately assess disclosures provided by dealers on the basis of the industry standard, for example that prepared by ISDA. Additionally, RFQ or electronic trading platforms may be better positioned to provide such upfront disclosures, but only if technologically feasible.

I. 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?*

The provision of upfront disclosures should generally be standardized across all transactions (*i.e.*, disclosures should be general rather than transaction-level) except that dealers should be given more flexibility in the provision of disclosures to sophisticated counterparties. There should be no mandated upfront disclosure requirements other than basic disclosures relating to conflicts of interest and fair dealing *etc.* which may already be required under applicable law (*e.g.*, under Part

[18] *See, e.g.*, ISDA's recently amended Dodd Frank disclosures available at https://www.isda.org/book/isda-general-disclosure-statement-for-transactions/.

23 of the CFTC Regulations). For example, § 23.431 of the CFTC Regulations already requires extensive disclosures, as follows:

> Disclosures of material information.
>
> (a) At a reasonably sufficient time prior to entering into a swap, a swap dealer or major swap participant shall disclose to any counterparty to the swap (other than a swap dealer, major swap participant, security-based swap dealer, or major security-based swap participant) material information concerning the swap in a manner reasonably designed to allow the counterparty to assess: (1) The material risks of the particular swap, which may include market, credit, liquidity, foreign currency, legal, operational, and any other applicable risks; (2) The material characteristics of the particular swap, which shall include the material economic terms of the swap, the terms relating to the operation of the swap, and the rights and obligations of the parties during the term of the swap; and (3) The material incentives and conflicts of interest that the swap dealer or major swap participant may have in connection with a particular swap, which shall include: (i) With respect to disclosure of the price of the swap, the price of the swap and the mid-market mark of the swap as set forth in paragraph (d)(2) of this section; and (ii) Any compensation or other incentive from any source other than the counterparty that the swap dealer or major swap participant may receive in connection with the swap.[19]

Further, the CFTC Regulations not only require that all applicable material information relating to swaps must be disclosed to a dealer's counterparty, but that such information must be provided in a fair and balanced manner, as required by § 23.433:

> Communications—fair dealing.
>
> With respect to any communication between a swap dealer or major swap participant and any counterparty, the swap dealer or major swap participant shall communicate in a fair and balanced manner based on principles of fair dealing and good faith.[20]

Accordingly, as noted above, at a minimum, the Final Report should be reconciled with the CEA, existing CFTC Regulations and current CFTC enforcement precedents.

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.*

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[19] *See also* note 15 *infra* listing CFTC enforcement actions relating to disclosures of dealers' hedging and pre-hedging practices.

[20] *See* § 23.433 of the CFTC Regulations.

Please see the response to ***Question 13*** above.

J. 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.*

No. There should be no requirement of transaction-by-transaction disclosures except as required by applicable law[21] because it is impractical and unnecessary for a dealer and counterparty, in every instance, to negotiate an agreement as to how a dealer will pre-hedge its trades, especially if pre-hedging is done on a portfolio basis and not on a trade-by-trade basis (which essentially would require that dealers pre-hedge only on a pass-through basis where each pre-hedged swap is attributable to each prospective swap with a counterparty).

While trade-by-trade disclosures may have utility in the context of large transactions that may have significant market-moving effects, in order to provide counterparties with better informed consent, where feasible with respect to a given asset class; however, that determination should be within a dealer's discretion to decide when a transaction would meet the large transaction requirement and thus require an additional transaction-level disclosure, and the content of any such disclosures should be decided by the dealer as well. Also, with respect to OTC derivatives in particular, dealers may already engage with counterparties in the normal course of business to discuss the potential effects of market-moving transactions and that such effects are factored into the pricing that is provided.

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.*

Yes, such disclosures would present an operational and logistical challenge for both dealers and trading platforms. Additionally, it would hinder the process of obtaining a quotation in which speed is paramount, thus any temporal lags between the time it takes for a dealer to solicit and a counterparty to give consent could render any quotations provided inaccurate or, worse, useless as they would no longer represent the same moment-in-time as when they were initially requested by a counterparty. This could have impacts on a systemic basis also where external market factors are at play.

K. Post-trade disclosure

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

While post-trade disclosures should not be mandated in general, counterparties and dealers should be free to bilaterally and contractually negotiate any disclosure arrangements that suit both parties if counterparties believe it would be beneficial to them and dealers believe that they

[21] *See, e.g.*, the discussion of § 23.431(a) of the CFTC Regulations above.

could provide such disclosures without compromising their own proprietary information. In particular, a dealer's pre-hedging trade is a proprietary position that occurs outside of a dealer's relationship with their counterparties, and any mandated disclosure would involve a dealer's proprietary information and methods, thus, the Final Report should not recommend any approaches that would mandate the provision of post-trade disclosures in any circumstances.[22]

It should be sufficient for a dealer to clearly disclose their conflicts of interest rather than their exact trading positions unless there is compelling evidence that a dealer's actions have compromised market integrity, as discussed in response to ***Question 10*** above. In such cases, if a counterparty is able to satisfy the initial burden of proof to demonstrate likelihood of a dealer's wrongdoing, a regulatory body could decide whether a post-trade review and disclosure should be undertaken.

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?*

Please see the response to ***Question 17*** above. The Final Report should not recommend any approaches that would mandate the provision of post-trade disclosures in any circumstances, be prescriptive as to the format of such disclosures or suggest that their provision should be standard market practice, as that would be an anti-competitive practice.

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.*

It would not be practical to provide post-trade disclosures with respect to RFQs and electronic trading platforms, and such a requirement would represent a significant compliance burden for the dealers and the platform providers (and, as stated above, may disclose the dealer's broader proprietary trading strategy or hedge position to the counterparty).

L. 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.*

As noted above, counterparties are free to bilaterally negotiate terms with dealers if they do not consent to pre-hedging or would like certain controls implemented with respect to pre-hedging

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[22] Note that § 23.431(d) of the CFTC Regulations already requires post-trade disclosures of daily marks, *however,* this requirement specifically states that: "the swap dealer … is not required to disclose to the counterparty confidential, proprietary information about any model it may use to prepare the daily mark…".

(*e.g.*, transaction-by-transaction notification). In such cases, dealers should be expected to comply with any such contractual terms just as they would with any other contractual terms. This approach would not present any unique risks to counterparties other than those discussed already above, but one should note that counterparties with such arrangements in place may have reduced access to liquidity and/or be offered higher prices by dealers as a result.

Furthermore, as noted above, the CFTC Regulations do not require a dealer to obtain a counterparty's consent to use the material economic information of a swap if the dealer intends to enter into a "hedge or mitigate any exposure created by [such counterparty's] swap…".[23]

➢ ***Recommendation B4:*** *Dealers should implement appropriate compliance and supervisory arrangements for pre-hedging including:*
 I. Supervisory systems and reviews; and
 II. Trade and communications monitoring and surveillance.

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.*

As discussed in response to ***Question 11*** above, with respect to bilateral OTC transactions, a prior standing negative consent of the counterparty should be sufficient, rather than an affirmative consent of the counterparty on a trade-by-trade basis.

As discussed in response to ***Question 10*** above, if technologically feasible and possible for the specific market/asset class, competitive RFQ platforms could make general disclosures regarding the effects of pre-hedging to a counterparty prior to the counterparty submitting such RFQ or could allow a counterparty to request a quote only from dealers who do not pre-hedge. It would not be otherwise feasible for dealers to provide transaction-by-transaction disclosures and thus they should not be required in such instances unless they were bilaterally negotiated with a counterparty.

As acknowledged in the Consultation Report, "clients on electronic trading platforms are generally sophisticated institutional investors who may not need disclosure and would prefer to avoid delay in the speed at which their trades are being executed." As a result, dealers should not be required to obtain explicit prior consent from a counterparty for transactions on electronic trading platforms, but should obtain a prior standing negative consent.

M. 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?*

Standalone post-trade reviews should not be mandated in the normal course of business. Post-trade reviews should be conducted only for monitoring and supervisory purposes (as with any

[23] *See* § 23.410(c)(2)(ii) of the CFTC Regulations.

other internal monitoring or auditing of business activity), or when there is a dispute as to whether market integrity was compromised.

➢ ***Recommendation B5:*** *Dealers should appropriately manage access to, and prohibit misuse of, confidential client information and adequately manage any conflicts of interest that may arise in relation to pre-hedging. Dealers should consider establishing, monitoring, and regularly reviewing appropriate physical and electronic information controls to align with any changes to the dealer's business risk profile.*

N. 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?*

No. As discussed in response to ***Question 11*** above, no recommendations in the Final Report should impose duplicative requirements on existing compliance obligations, and such requirements would be duplicative with existing policies and procedures for dealers relating to conflicts of interest and market integrity.

Additionally, it may not be feasible for dealers to draw staunch lines between pre-hedging and inventory management in all cases, and it should not be necessary for them to do so absent compelling evidence that a dealer's pre-hedging has compromised market integrity. Further, it is not clear what benefits this distinction will provide to their counterparties.

➢ ***Recommendation B6:*** *The dealer should maintain adequate records of pre-hedging to facilitate supervisory oversight, monitoring, and surveillance.*

O. 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?*

As discussed in response to ***Question 11*** above, the Final Report should not recommend any required recordkeeping to facilitate supervisory oversight, monitoring and surveillance of dealers' pre-hedging activities to the extent that any such recommendations would be duplicative of existing compliance obligations that would already address such conduct. To that end, in the U.S., dealers are already subject to requirements that would allow for the reconstruction of circumstances surrounding trading decisions.[24]

P. 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.*

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[24] *See, e.g.*, Part 43 and 45 and Subpart F of Part 23 of the CFTC Regulations.

Yes. Please see the responses to ***Question 1*** and ***Question 7*** above with respect to the FX Global Code, the Global Precious Metals Code and the FMSB Large Trades Standard, in particular.

II. Further Comment

SFA again thanks IOSCO for the opportunity to submit this letter. SFA's membership stands ready to provide further input regarding this important topic and our comments in this letter. If you have any questions about this matter, please contact David B. Dwyer, General Counsel, Policy & Regulatory Affairs, at david.dwyer@structuredfinance.org.

Sincerely,

David B. Dwyer
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The Structured Finance Association

Cc: Peter Y. Malyshev
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