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Pre-hedging disclosure - A justifiable defence?

A follow-up to ‘Primary Market Manipulation - An Emerging Surveillance Risk’.

Pre-hedging disclosure - A justifiable defence?

This is a follow-up to the previous article – 'Primary Market Manipulation - An Emerging Surveillance Risk'. That report created a lot of interest and discussion, particularly around the theme of pre-hedging. Those discussions justified a follow-up to provoke further useful discussion on this important topic.

Broader Issues

Whilst the previous article spoke of market manipulation related to primary market activity, the problem actually relates to a wider set of problems; those of all financial market transactions where a private fixing is involved.

In this case, the term private fixing relates to any case where a transfer of risk off exchange takes place between parties at a price determined by reference to a screen price. The screen will display prices where market participants are willing to trade. For example, as described in Commodity Futures Trading Commission (CFTC) vs John Patrick Gorman III, a bond issuance and issuer swap were priced, using the '19901' screen which displayed prices from a SEF (Swap Execution Facility) Broker Firm, including prices for U.S. dollar interest rate swap spreads with a ten-year maturity ("Ten-Year Swap Spreads").

We described enforcement cases related to the fixed income and FX markets in all cases where a screen fixing was used to determine a risk transfer price between parties. However, the commodity and equity markets also feature trades conducted on the same basis. Whilst enforcement cases may not have featured in these markets, the same problems will almost certainly exist.

Risk Assessment

Expressed as a general principle, the problem arises when a large volume of risk is priced over the counter with reference to a screen, where the contemporaneous volumes may be much lower. The issue is particularly acute where the reference instrument (i.e., the instrument whose price is displayed on the screen) generally trades in low volume and whose price is volatile.

In summary, the worst-case scenario is:

An ***extremely large trade*** is priced using a ***fixing screen, which handles low volumes*** on ***illiquid, volatile*** instruments.

The best-case scenario, where the risk of manipulation is low, is one where:

A ***small trade*** is priced using a ***fixing screen***, ***which handles huge volumes*** of ***liquid, low-volatility*** instruments.

To some extent, we can break the problem down into two separate components: those of pre-hedging and disclosure and that of market manipulation.

Pre-Hedging

It seems logical that, when agreeing to a very large, risky trade with a customer, two possible approaches to pricing can be taken.

1. The customer assumes the execution risk. In this case, the bank performs all the required hedges and passes on the weighted average price to the customer, plus an agreed profit margin. In this case, the question of pre-hedging is not a relevant one; the actual execution prices of the hedge trade achieved by the bank are simply passed on to the customer and no screen price needs to be referenced.
2. The bank assumes the execution risk. In this case, the agreed trade price includes a premium that the bank charges in exchange for assuming the entire execution risk (the risk that the market moves against the bank before the hedging can be completed). In this case, it seems reasonable that pre-hedging would not be allowed since the bank is explicitly charging a premium for assuming the risk that pre-hedging negates. Additionally, pre-hedging is likely to cause the price of the reference instrument to move against the customer, thus prejudicing the customer's interests.

Both options 1 and 2 seem reasonable. However, it seems that it would be unreasonable to agree option 2 with a customer, quote a full-risk transfer price and then engage in pre-hedging. Charging a full transfer price (in exchange for all the execution risk) and mitigating that risk by pre-hedging (and in doing so, possibly disadvantaging the customer) seem incompatible.

Whilst such an action isn't necessarily market abuse, it seems dishonest and possibly fraudulent. In its accusations against Westpac, ASIC (Australian Securities and Investment Commission) labels the behaviour "unconscionable conduct". Additionally, within the 'ESMA (European Securities and Markets Authority) Evidence on pre-hedging' published July 2023, ESMA finds insufficient evidence to ban the practice of pre-hedging outright but concludes "that pre-hedging... might give rise to conflicts of interest or abusive behaviours".

Additionally, in both cases, but particularly with option 1, there is a risk of over-facilitation by the executing trader. This is essentially front running; just before executing the hedge / pre-hedge trades, the trader executes trades for his own account in the knowledge the large amount of risk associated with hedging the client trades will impact the market price and profit the own-book trades.

Many banks have a pre-agreed right to pre-hedge stated in various disclosure documents provided to their customers. Whilst that might help, there is undoubtedly a disclosure issue at play which needs to be thought through carefully on a case-by-case basis. For example, in Mizuho Capital Markets LLC enforcement action brought by the CFTC, Mizuho would pre-disclose to its client that it "may" seek to pre-hedge transactions and that pre-hedging "may" affect the price of the underlying asset, but Mizuho did not specify to clients that it might engage in trading in the "minutes or seconds" before execution. The CFTC found that trading FX spot in this manner allowed Mizuho to hedge its spot exposure at a more favourable rate than would have otherwise been available. This resulted in counterparties obtaining less favourable exchange rates on the forward transactions at issue.

The CFTC found that Mizuho's failure to disclose its pre-hedging activity with sufficient specificity violated Section 4s(h)(3)(B)(ii) of the Commodity Exchange Act and 17 C.F.R. §23.431(a)(3)(ii), which requires swap dealers to disclose "[a]ny 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." The CFTC explained that because Mizuho had an incentive to trade in the minutes or seconds before the transaction to obtain a more favourable spot rate on its pre-hedges, which could negatively affect the rate its clients would receive on the transaction, Mizuho had a conflict of interest that needed to be adequately disclosed. Based on the alleged inadequacy of the disclosure, the CFTC also charged Mizuho with violations of Section 4s(h)(3)(C) of the CEA and 17 C.F.R. §23.433, which requires that swap dealers "communicate in a fair and balanced manner based on principles of fair dealing and good faith," and with a failure to supervise under Section 4s(h)(1)(B) of the CEA and 17 C.F.R. §23.602(a) based on alleged shortcomings in Mizuho's policies and procedures related to its pre-hedging practices.

Similarly in the CME (Chicago Mercantile Exchange) NOTICE OF DISCIPLINARY ACTION - COMEX 19-1158-BC, dated 19 May 2022, against J. Aron & Company LLC, the CME noted 'A party acting principally in a block trade negotiation that plans on engaging in pre-hedging activity must ensure it is clear to its counterparty that the party is trading principally, and, as such, owes no agency duties to the counterparty. In that regard, initial disclosures in account opening agreements or other similar communications may be deemed insufficient in the event that the block trade negotiation itself is indicative of the party assuming agency duties to the counterparty.'

Market Manipulation

It might be possible to argue that pre-hedging is permitted even when the customer trade is executed at a price which references a screen price. However, regulators are clear that such permission does not create a licence to manipulate market prices.

Pre-hedging activity in this case should be executed in such a manner as to create minimal market impact. Recklessly creating market impact by executing large trade volumes just before the screen price is referenced is likely to constitute market abuse both with and without pre-hedging rights. Indeed, it seems reasonable that traders pre-hedging transactions have a general responsibility to create minimal market impact ahead of private fixings. For example, the FICC Markets Standards Board, "Standard for Execution of Large Trades in FICC Markets," notes that "Pre-hedging should be reasonable relative to the size and nature of the anticipated transaction."

The amount of pre-hedging and the hedging mechanism employed to avoid unfair market impact and the risk of creating a false or misleading impression of the market price is extremely nuanced and will depend upon the market and the circumstances. This has been highlighted by bodies such as the Global Foreign Exchange Committee within the FX Global Code where they note that in assessing whether pre-hedging is being undertaken in accordance with the principles outlined within the Code, a "Market Participant should consider prevailing market conditions (such as liquidity) and the size and nature of the anticipated transaction."

Regulatory Scrutiny

The regulatory complaints and prosecutions brought by various global regulators clearly indicate that there is significant concern that primary market transactions are not systematically monitored for market abuse and customer conflicts of interest.

In many banks, primary market transactions are monitored on a random selection basis. Selected transactions undergo a “deep dive” where communications associated with the trading activity are analysed and, in some cases, the hedge trades themselves are analysed.

This approach is unlikely to be acceptable to regulators and the recent enforcement cases make clear that this is an area of increased regulatory focus.

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