State Street Corporation
One Congress Street
Boston, MA 02114-2016
statestreet.com

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International Organization of Securities Commissions
Calle Oquendo 12
28006 Madrid
Spain

Submitted via: online survey

Re: IOSCO Consultation Report on Pre-Hedging

Questions for consultation

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?**

State Street appreciates the opportunity to comment on IOSCO's Consultation Report on Pre-Hedging. We support this work at the global level and consider that a more in-depth examination of current market practices is needed.

As a general comment, we have contributed to and support the response submitted by the Global Financial Markets Association ("GFMA") and the points made there. In our response we would like to focus more specifically on certain adverse impacts that we see arising in the ETF asset class.

Broadly, we believe that when trying to identify a clear definition of legitimate pre-hedging practices the following principles should be taken into account:

- Pre-hedging should always be to the benefit of the client and executed in a way that the liquidity provider recognizes and minimizes the market impact, particularly for pre-hedging in the context of electronic trading, including competitive requests for quotes (“RFQs”)
- When assessing market impact, some asset classes such as ETFs deserve special consideration as liquidity providers may more easily be able to discern the direction of a particular trade
- In such areas, we consider that Industry codes and standards should be incentivized and could help give effect to IOSCO’s guidance. A positive example in this area has been the FX Global Code on policies and procedures for pre-hedging. A similar code does not exist in other asset classes such a ETFs.

In the below answers, we expand on the implications that pre-hedging may have for ETFs trades and RFQs, and the likelihood we see that information from the RFQ process could be used to draw conclusions on the effect on prices.

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?**

We agree with the definitions provided of risk management.

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.**

We believe that the Global FX Code already adequately addresses this point for transactions in FX. However, we see more work be required specifically for ETF trades. We have concerns for pre-hedging in a context where there are competitive RFQs which can lead to detrimental price impact for clients if multiple RFQ participants pre-hedge.

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

For the most part, we do not believe that pre-hedging small trade sizes in liquid market is likely to be of material benefit to the client. However, it is challenging to identify liquidity of a market in advance, therefore limiting pre-hedging by size would not likely be an optimal approach.

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?**

We believe that dealers should look to use inventory prior to pre-hedging. If dealers hold sufficient inventory to manage liquidity for a client order, then this should be used in preference to pre-hedging.

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 a starting point, the size of the trade compared to the available market liquidity should be taken into account. For RFQs relating to ETF orders, we also believe that use of pre-hedging should be more restrictive than in other asset classes, as it is common practice for multiple RFQs to be sent for a single order, so we note that that the price of an ETF could be moved significantly if all liquidity providers attempted to pre-hedge the same exposure on a single ETF order.

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

We agree with the provided definitions.

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.**

We believe that the liquidity provider should always be able to demonstrate that they are using pre-hedging as a way to achieve a better price for the client. In particular, the liquidity provider should be able to demonstrate whether they are getting a good price and that they are not moving the market excessively.

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?**

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?**

Please see our response to question 6.

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

We agree with this recommendation, it is our view that there should be far more transparency and reporting around pre-hedging by market participants.

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

We believe that upfront disclosure would be most effective for clients, as this allows them to choose the counterparties they wish to engage with on a greater information basis.

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?**

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**

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.**

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.**

We do not believe there are any barriers to this.

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

While we believe that post-trade disclosure would benefit clients in determining which counterparties are engaging in pre-hedging on which transactions, we believe that upfront pre-trade disclosure would be more informative to clients.

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?**

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**

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.

We believe that clients should be entitled to request that pre-trading not occur on certain trades, particularly in the case of competitive RFQ and trades occurring off-order book, where the use of pre-trading may result in a detrimental price being achieved.

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.**

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?**

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?**

We believe that requiring these internal controls would be beneficial to clients, as it would allow for easier identification of whether market participants are using pre-hedging for their own benefit or to reduce costs, however we are uncertain as to the feasibility of implementing this program.

24. **What level of detail would be sufficient to have adequate records of pre-hedging activity to facilitate supervisory oversight, monitoring and surveillance?**

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

We believe that the Global FX Code has been effective in addressing many of the recommendations raised in this consultation, and we would like to have similar frameworks applying to other asset classes.