Japan Securities Dealers Association
JSDA

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International Organization of Securities Commissions (IOSCO)
Calle Oquendo 1228006
Madrid, Spain

Comments on “Pre-hedging”

Dear Sir/Madam,

The Japan Securities Dealers Association (JSDA[1]) appreciates the opportunity to provide the following comments on “Pre-hedging” published on November 24, 2024, by the International Organization of Securities Commission (IOSCO), and express our appreciation for IOSCO’s ongoing efforts in this area.

The JSDA would like to submit the comments received from our member firms, attached, and hope that the comments will be considered as the contents of the report are finalized going forward.

Sincerely yours,

HISHIKAWA Isao
Chief Officer for International Affairs & Sustainable Finance
Japan Securities Dealers Association

[1] The Japan Securities Dealers Association (JSDA) is an association that functions as both a self-regulatory organization and as an interlocutor between market participants and various stakeholders, including government authorities. Its legal status is a Financial Instruments Firms Association authorized by the Prime Minister. Both functions operate independently. The JSDA is made up of approximately 465 members that include securities firms and other financial institutions running securities businesses in Japan.

JSDA Comments to IOSCO Consultation Report "Pre-hedging"

Question		Comments
Definition of Pre-hedging		
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 Japan Securities Dealers Association received comments from member firms (broker dealers) indicating that more clarification and illustrative examples would be helpful. In particular: - One member firm indicated that they would appreciate more specific examples (by type of financial instrument) of what constitutes pre-hedging under the IOSCO's definition. The same firm also would appreciate if IOSCO could provide a definition of an "anticipated client transaction" and more specifics on what constitutes "information about an anticipated client transaction". - Several member firms feel the precondition for pre-hedging in (ii) that the trades are "executed after the receipt of information about an anticipated client transaction" may be interpreted too broadly. If generally defined in this manner, the broad definition can lead to confusion among clients, sales divisions and dealers regarding whether certain information should be considered information about an anticipated client transaction (e.g., cases where an indication or a general idea of buying/selling interest is simply conveyed without committing to a transaction). They instead suggest changing the wording to clarify that the information on which pre-hedging is conducted is predicated on a client's intent to proceed with the transaction-- for example, "after the receipt of a firm request for quote from the client". - One member firm indicated that they would appreciate if IOSCO could consider cases where the prices are not fixed but the point in time where the trade will take place has been pre-determined not as pre-hedging, but rather inventory management or hedging (e.g., JGB closing price transactions and average price orders in bidding). They believe this idea is aligned with principle 11 of the Global Foreign Exchange Code of Conduct and its associated guidelines. - For the final pillar (iii) in the definition, in order to clarify the objectives for pre-hedging, one member firm suggested that the wording be amended to "the trades are executed to manage risk, benefit client interest, and minimize market impact in connection with the anticipated client transaction". - One member firm noted that pre-hedging can sometimes occur independently, or it can be done on a portfolio basis. - One member firm argued that the proposed definition should not start with a reference to the expression "in compliance with applicable laws and rules, including those governing frontrunning, trading on material non-public information/insider dealing, and/or manipulative". They noted that including such references about violations of applicable laws and rules beyond pre-hedging makes the definition difficult to understand. Additionally, complying with such laws and rules is naturally assumed. Therefore, the definition should focus exclusively on pre-hedging. Even if such language about applicable laws and rules is necessary, it should be included in the overarching guidance, not in the definition.
Determining When Pre-hedging is Acceptable		
A1.	**Dealers should undertake pre-hedging only for a genuine risk management purpose**	
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?	The JSDA received the following comments from member firms: - The term "genuine risk management" is ambiguous, and as such, if an alternative term that more clearly embodies the intended concept could be found (e.g., risk management that takes into account market impact and client interest), it would be appreciated. - There is no need to include the term "genuine". The risks considered by dealers should be left to the dealers' discretion as long as they can explain them, and as such, it is not necessary to define what constitutes a "genuine" risk. Moreover, this term misguided as there is no such thing as a "non-genuine" form of risk management. - The methods of risk management differ depending on the trading entity and its purpose, and there is no cross-cutting concept that can be applied universally.

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.	The JSDA received comments from member firms indicating that pre-hedging should be acceptable regardless of liquidity. In particular, respondents mentioned: - Even if there is sufficient liquidity in underlying instruments, due to potential exposure to the risk of price fluctuations caused by trading hours and information affecting market prices, there are cases where pre-hedging would provide positive benefits for the client, and as such, pre-hedging should be acceptable. - In a competitive bid where multiple dealers are providing quotes in response to client inquiries, there are cases where pre-hedging may help reduce costs. Having said this, it is also important to bear in mind the possibility that multiple dealers would manage their inventory in the case of such a competitive bid. - The appropriateness of pre-hedging should not be determined solely by market liquidity. Market liquidity is not static and is influenced by multiple factors, making it difficult to define objectively. In other words, liquidity is difficult to predict, and volatility can vary greatly; even in normally liquid markets, liquidity can rapidly diminish under certain conditions, necessitating pre-hedging. - When pre-hedging, dealers not only consider liquidity, but also other factors such as the number of dealers in competition.
4	Can there be a genuine need to pre-hedge small trade sizes in liquid markets for risk management purposes?	The JSDA received comments from member firms indicating that pre-hedging should be acceptable regardless of trade size. In particular, respondents mentioned: - Even for small trade sizes in liquid markets, pre-hedging helps to reduce risk and is necessary. - There can be a genuine need to pre-hedge small trade sizes in liquid markets, as there are situations where many small-scale transactions are concentrated; pre-hedging should be recognized as a form of risk management to prepare for such transactions. As mentioned in Q3, liquidity is difficult to predict, and volatility can vary greatly; even in normally liquid markets, liquidity can rapidly diminish under certain conditions, necessitating pre-hedging. - Pre-hedging should be acceptable regardless of the trade size in relation to market liquidity, if it helps to reduce risks and provides benefits to the client. If, for example, pre-hedging is not permissible for small trade sizes across the board, and a dealer must use the inventory they hold to offset risk for such small trades, in the event that a larger transaction (relative to market liquidity) is anticipated, the more likely it is that pre-hedging/hedging may not be effectively conducted, leading to a potential risk premium that will have to be passed on to the client. In other words, pre-hedging should be allowed regardless of trade size because management of inventory risk is always necessary. As a side note, from this perspective, the trading cycle portrayed in 'Figure 1: Pre-hedging schematic' of the consultation report—inventory management --> pre-hedging--> hedging—is oversimplified. The reality is that where multiple trades are concurrently being pre-hedged and then hedged, inventory management is also being conducted alongside this. This should be made clear in the report. (The same comment applies to Q5 and Q6)

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 JSDA received comments from member firms indicating that pre-hedging should be acceptable regardless of the inventory of the dealer. In particular, respondents mentioned: - Pre-hedging is acceptable when it is considered to be in the interest of benefiting the client, and if dealers who hold inventory should use such inventory rather than pre-hedge, there is the risk that the dealer may not be able to provide the best price for the client. Using inventory changes inventory risk, and thus, the use of inventory vs. pre-hedging should both be options available to the dealer at the time it is necessary. Regardless of inventory, if the market risk associated with the anticipated transaction is large relative to market liquidity or the risk tolerance of the dealer, and it is considered in the interest of the client, pre-hedging should be allowed. - When a dealer holds inventory prior to receiving information about an anticipated client transaction, in general, that inventory is set up for potential trading opportunities with other clients. As such, pre-hedging should be permitted regardless of the dealer's position at the time of the receipt of the information about an anticipated client transaction, but at least up to the upper limit of the amount of the said anticipated transaction. - Dealers should not be required to use inventory before pre-hedging. Constraints should not be placed on methods intended to minimize market impact by dealers, and thus how dealers conduct pre-hedging and utilize inventory should be left to their discretion. The purpose of holding inventory is not necessarily to respond to anticipated transactions, and forcing dealers to use inventory to pre-hedge anticipated transactions would restrict dealers and their risk management methods, potentially hindering optimal risk management.
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.	The JSDA received comments from member firms pointing to several factors that dealers should consider in determining the size of pre-hedging. In particular: - Transaction size, instrument type, and quotation environment, etc. are all factors that dealers could potentially consider in determining the size of pre-hedging. Of these factors, the quotation environment changes from moment to moment, and as such, it is believed that pre-hedging should be allowed at least up to the upper limit of the anticipated client transaction as predicted by the dealer. Additionally, if the pre-hedging is conducted with a product that is different from the anticipated client transaction, then it would be appropriate to consider Greek based upper limits. - The amount of pre-hedging could potentially be determined by a multitude of factors including transaction size, instrument type, and quotation environment. When considering establishing rules such as upper limits on amounts, it would be appropriate to consider Greek-based standards for each type of instrument. In particular, when determining the size of pre-hedging for derivative transactions, it is necessary to take into account correlations between products and correlations with index values. - The amount of pre-hedging should be determined by transaction size, market conditions, and time before the anticipated execution. Imposing restrictions would create significant constraints when market conditions change or when managing inventory while processing multiple anticipated orders, making risk management difficult. - If limits are imposed solely based on the notional amount or risk of each individual transaction, dealers would not be able to "bundle" risk hedges for anticipated transactions from multiple counterparties, which would impact liquidity provision by the dealers.

A2.	**Dealers should (i) act fairly and honestly to clients and (ii) undertake pre-hedging only with the intention to benefit the client**	
Client benefit		
7	Do you agree with the concept of client benefit described above?	The JSDA received the following comments from member firms: - Several member firms agreed with the concept of undertaking pre-hedging only with the intention to benefit the client, with one member firm adding, however, that they would like for IOSCO member jurisdictions, when considering their own regulations for pre-hedging, to be aware that there may be cases where, while pre-hedging is performed with the intent to benefit the client, in practice, the act of pre-hedging does not necessarily always result in that client benefit; they noted that they would like such cases to not be immediately considered violations of rules or regulations. - Another member firm added that pre-hedging should be viewed as an act of risk management by dealers to facilitate client transactions. They also noted that it is important not only to have the intention of benefiting the client but also to ensure that clients are not affected detrimentally in the process.
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.	The JSDA received comments from member firms raising issues about the concept of sharing financial benefits derived from pre-hedging. In particular: - One member firm indicated that they find the concept of sharing financial benefits between the dealer and client to be slightly misguided -- in their view, the expected financial benefits of pre-hedging are included in the price offered to the client. - Another member firm indicated that they do not believe the financial benefits should be shared, because (1) any losses incurred from pre-hedging are not shared with the client, and (2) when hedging with alternative instruments, it would be difficult to calculate the proportion that would be considered "fair" to share. - Similarly, another member firm added that, to begin with, calculating the financial benefit of a pre-hedged transaction is difficult. They also noted that any decision to share certain monetary gains should be left to the discretion of the liquidity providers, who notably also are the ones taking on the risk of ‘failed’ pre-hedged transactions and their associated costs. They also point out that in Japan, depending on how profits are shared, there may be a possibility of regulatory prohibition of the provision of profits.
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?	The JSDA received the following comments from member firms: - One member firm responded that the decision whether or not to pre-hedge should not be based on whether it is in the interest of the client or the dealer-- rather, in their view, pre-hedging is based on the premise that it leads to positive outcomes for the client, and the dealer's own risk management is connected to the client's benefit. However, they also noted that the act of pre-hedging does not necessarily always lead to the best prices for the client. - Another member firm responded that they preferred the latter (i.e. that the dealer pre-hedges for its own risk management and does not detrimentally affect the client), as proving the "intention" to benefit clients is difficult.

A3.	**Dealers should (i) minimise market impact and (ii) maintain market integrity when pre-hedging**	
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?	The JSDA received comments from member firms indicating that while they agree there is a need to consider market impact when conducting pre-hedging, there is a limit to demonstrating the intent and actions taken. In particular, respondents indicated: - The dealer should give due care to ensure that pre-hedging and the closing out of such positions have minimal market impact, and to this end, dealers should consider establishing internal controls to ensure appropriate pre-hedging. However, determining the appropriate level of such internal controls requires thorough discussion, as identifying pre-hedging transactions is technically challenging, and establishing these controls involves significant effort and cost. - What dealers can do is endeavor to reduce the market impact of their pre-hedging practices: however, to demonstrate this may be practically difficult. - In practice, it would be very difficult to demonstrate a dealer's intent, and dealers should not be required to demonstrate or document their intentions. For example, if multiple dealers have the same or similar 'anticipated client transaction', it is expected that pre-hedging by multiple dealers will occur simultaneously or in close timing. In such cases, it is considered almost impossible to demonstrate that the pre-hedging conducted by one dealer was an "action taken to minimize market impact." This is particularly true in highly volatile markets where there are many other variables going into the decision of a trader who may be buying / selling for a multitude of reasons. In addition to the above, one member firm noted that using the word ‘minimize’ in the context of market impact without clear qualification could potentially discourage pre-hedging on a large scale, hindering what might have been the optimal choice for clients. They suggested the wording be softened to "reduce" or "control" such market impact.
Management of conduct risk from pre-hedging		
B1.	**Dealers should document and implement appropriate policies and procedures for pre-hedging**	
Policies and procedures		
11	Do you agree with this recommendation on appropriate policies and procedures for pre-hedging? If not, please elaborate.	The JSDA received comments from member firms on the whole in agreement with the recommendation itself. However: - One member firm responded that even so, they believe it is necessary to ensure that actions taken in good faith for risk management purposes are not restricted. - Another member firm also noted that they would appreciate if pre-hedging is not unnecessarily restricted.

B2.	**Dealers should provide clear disclosure to clients of the dealer's pre-hedging practices**	
Disclosure		
12	What type of disclosure would be most effective for clients? Why?	The JSDA received comments from member firms in general indicating that upfront disclosure through the dealer's website would be effective and feasible. In particular: - Several member firms indicated that upfront disclosure of a firm's general policy on pre-hedging on its website, etc. would be ideal and practical. - One member firm pointed out that upfront disclosure is feasible and widely accepted by many market participants. Based on this fact, they suggested it might be preferable to follow the existing FX Global Code disclosures. They also noted that the decision of whether dealers go beyond upfront disclosure of their general policy (e.g. whether to disclose additional content through upfront disclosure or conduct other types of disclosure) should be left to the dealer's discretion, based on various factors such as the client's level of sophistication and types of transaction methods. - One member firm added that a practical approach would be to disclose through a website, etc. a disclaimer that the dealer may pre-hedge, or take on a similar position, and the impacts of such activities. - One member firm mentioned that it would be also necessary to provide a means for clients to express their dissent to pre-hedging in the disclosure. - One member firm noted that it would be difficult to disclose this information to clients before each transaction, much less to obtain consent from clients each time this pre-trade disclosure on pre-hedging is conducted. Transactions are diverse, and the likelihood of a transaction, trade details, and number of dealers participating in a bid vary. Particularly, when the same stock is traded with separate counterparties, they argue that if there are differences in whether or not said counterparties consent to pre-hedging, it would be difficult for the dealer to handle each transaction individually.
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 upfront disclosures?	The JSDA received the following comments from member firms regarding upfront disclosure: - Several member firms indicated that it is preferable to follow the existing FX Global Code disclosures where dealers make upfront disclosures through their company website, etc. One member firm added that they have no objections to providing general disclosures upfront, regardless of the factors. - Another member firm noted that upfront disclosure should be limited to general information, because the approach to pre-hedging largely depends on the traded instrument, liquidity and market conditions. Additionally, it is conceivable that there are some clients for whom no explanation of pre-hedging is necessary, but in any event, many clients require dealers to respond swiftly in trading. Considering these variations and clients' needs, the member firm indicated that a flexible framework for pre-trade disclosure would be appreciated.
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.	Regarding upfront disclosure, the JSDA received comments from member firms raising the following as the minimum content for such disclosure: the possibility of conducting pre-hedging, the definition of pre-hedging, the purpose of pre-hedging, the instruments for which pre-hedging is conducted, the potential effects of pre-hedging, and the fact that clients may choose not to consent to the dealers' pre-hedging activities as well as the way to communicate dissent/withdraw consent. Another member firm responded that it would be preferable to follow the current FX Global Code disclosures for all transactions.

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.	The JSDA received comments from several member firms indicating that while proportional trade-by-trade disclosure is ideal, it should not be prescribed under rules but rather business practice at their discretion. In particular, respondents mentioned: - Trade-by-trade disclosure should be proportional to factors such as trade size and complexity, as well as the level of client sophistication, and the disclosure should also be easy to understand for clients. - In terms of practical response, trade-by-trade disclosure should be treated within the context of the general business practice existent for disclosure. To this end, the content of disclosure may be changed if necessary on an individual basis depending on factors such as the size and complexity of the transaction, and the client's level of sophistication. - The minimum content of individual trade-by-trade disclosures may include the period of a pre-hedge trade. This member firm also requested IOSCO to allow a certain level of flexibility for disclosure content so that dealers can provide necessary information depending on the clients when conducting trade-by-trade disclosure as a business practice. - (As a comment for Q15 Trade-by-Trade Disclosure, Q17 Post-Trade Disclosure, Q21 Explicit Prior Consent, Q23 Differentiation between Pre-Hedging and Inventory Management, and Q24 Records) Managing pre-hedging practices for each individual transaction per each individual client (as well as keeping records and conducting monitoring and surveillance of said disclosure) places too great a burden on dealers. The costs of establishing systems and personnel required for such new procedures are ultimately passed on to clients as transaction costs or embedded in the transaction price. Given that this is not necessarily in the best interest of clients, this member firm expressed its dissent with the said proposals. Also, another member firm noted that they do not consider the trade-by-trade disclosures practical or feasible to be implemented across all markets/transactions. However, they were of the view that in specific cases such as very large transactions, trade-by-trade disclosure may be required, and more careful pre-trade disclosure may be necessary for more complex transactions. They also noted that they believe trade-by-trade disclosure may prove particularly challenging in the context of electronic trading.
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.	The JSDA received the following comments from member firms: - One member firm noted that competitive RFQs involve quick inquiries from clients who, in general, have a high level of sophistication; as such, there are many cases in such an environment where trade-by-trade disclosure would be deemed unnecessary. - Another member firm mentioned that timing of specific disclosures related to transactions poses a challenge to providing trade-specific disclosure, as transactions for specific products can occur rapidly and may not leave sufficient time for a counterparty to receive and consider the content of the disclosure. - With respect to electronic trading, one member firm highlighted the concern with implementing a system infrastructure to fully digitize trading. In particular, they noted that in Japan, specifically for bond trading and OTC derivatives trading, voice quotes and orders are still the norm, and in a market where electronic trading is not mandated by regulation, digitizing trades would impose the burden of investment in systems on both dealers and investors. Given that the cost of dealers' investments in systems will ultimately be reflected in transaction costs and prices that are passed on to clients, the member firm argued that this would not be in the best interest of clients.

Post-trade disclosure		
17	Would clients benefit from post-trade disclosures about the dealer's pre-hedging practices in a transaction?	The JSDA received comments from member firms indicating that post-trade disclosure should not be mandatory under rules and flexibility should be allowed. In particular, respondents mentioned: - (As a comment for Q15 Trade-by-Trade Disclosure, Q17 Post-Trade Disclosure, Q21 Explicit Prior Consent, Q23 Differentiation between Pre-Hedging and Inventory Management, and Q24 Records) Managing pre-hedging practices for each individual transaction per each individual client (as well as keeping records and conducting monitoring and surveillance of said disclosure) places too great a burden on dealers. The costs of establishing systems and personnel required for such new procedures are ultimately passed on to clients as transaction costs or embedded in the transaction price. Given that this is not necessarily in the best interest of clients, this member firm expressed its dissent with the said proposals. - The content of the disclosure should vary based on the instrument, liquidity, market conditions, and client's level of sophistication. A one-size-fits-all approach to disclosure may in some cases lead to excessive burden on the dealer's end, which may then be reflected in transaction costs imposed to the client. This member firm requested for there to be room for flexibility. - The results of pre-hedging would depend on various factors such as transaction size, product type,and market conditions, making it impossible to compare cases with and without pre-hedging. Additionally, measuring the effects of pre-hedging (such as the degree of improvement in transaction conditions or impact on the market) and accurately analyzing whether it was objectively good or bad is practically difficult. Therefore, mandatory disclosure may not necessarily provide value, and it may be better for clients to engage in voluntary dialogue with dealers after transactions. However, post-trade disclosure may incur additional costs.
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?	The JSDA received the following comments from member firms: - Post-trade disclosure and prior agreement on such disclosure should be conducted voluntarily between the client and the dealer as needed. - The disclosure should be easy to understand for clients and be proportional to factors such as trade size, trade complexity, and level of client sophistication. - Agreeing on the nature and form of post-trade disclosure at the start of an engagement with a client would be natural-- however this should not be mandatory, and there should be flexibility in the approaches, making room for differences in whether or not an agreement from the client is necessary, as well as the content of the disclosure itself, based on trade size, trade complexity, and level of client sophistication. - Post-trade disclosure can sometimes be challenging to explain, and there may be items that cannot be disclosed. Therefore, if such disclosure is requested, such a request should be indicated before the transaction, and agreement on the feasibility of such disclosure should be reached beforehand. However, the necessity and content of the disclosure should be flexible to change based on the trade size, trade complexity, and the client's level of sophistication.
19	Are there any barriers to post-trade disclosure? Please differentiate between bilateral OTC transactions, competitive RFQs and prehedging in the context of electronic transactions, in particular in electronic trading platforms.	The JSDA received comments from member firms indicating that they do believe there are barriers. In particular: - One member firm indicated that there would be significant practical burden. They specified that if disclosure is based on objective data, the main barrier is that this data cannot be clearly identified, which would apply regardless of the nature of the transaction. The member firm argued that if post-trade disclosure becomes mandatory, dealers may be compelled to take measures that prohibit pre-hedging in order to avoid the risk of non-compliance. They underlined that this could negatively impact transaction prices and, in some cases, prevent dealers from engaging in clients' transactions or providing liquidity to clients and the market. - Another member firm noted that a one-size-fits-all approach to disclosure may in some cases lead to excessive burden on the dealer's end, which may then be reflected in transaction costs imposed to the client. This member firm requested for there to be room for flexibility.

B3.	**Dealers should obtain prior consent from the client**	
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 prehedging)? 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.	The JSDA received comments from member firms that were generally supportive of IOSCO's recommendation. However, member firms noted that: - Restrictions on dealers' ability to manage inventory risk may result in worse prices offered to clients, which would not necessarily be in their best interest. As such, it is necessary to put in place measures such as giving dealers the right to refuse the new client instructions. - If responding to such a request from the client is made obligatory, the market price provided to the client may be impacted, which is a potential issue/risk for the client. - Potential issues or risks associated with responding to the client request not to pre-hedge in relation to a particular transaction could include an impact on the transaction prices, and, in some cases, being unable to execute the transaction and provide liquidity. - While it would be important to allow clients the ability to explicitly inform dealers that they do not want pre-hedging to take place in relation to a specific transaction (or to revoke explicit or implicit consent to pre-hedging), at the same time, a flexible approach is necessary, such as providing clients the option of exercising their right to revoke consent to pre-hedging for specific time periods-- i.e., pre-hedging before vs. after receiving an RFQ. The option to selectively revoke consent is useful for clients, particularly in the case of relatively illiquid equity derivatives, from the perspective of determining whether the hedge is in the client's best interest.
21	Should dealers be required to obtain explicit prior consent to prehedge 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.	The JSDA received comments from member firms objecting to obtaining explicit prior consent from each client for each transaction. In particular, respondents mentioned: - Obtaining explicit consent would place too much of practical burden and cost. (As a comment for Q15 Trade-by-Trade Disclosure, Q17 Post-Trade Disclosure, Q21 Explicit Prior Consent, Q23 Differentiation between Pre-Hedging and Inventory Management, and Q24 Records) This firm argued that managing pre-hedging practices for each individual transaction per each individual client (as well as keeping records and conducting monitoring and surveillance of said disclosure) places too great a burden on dealers. It was their view that the costs of establishing systems and personnel required for such new procedures are ultimately passed on to clients as transaction costs or embedded in the transaction price. Given that this is not necessarily in the best interest of clients, this member firm expressed its dissent with the said proposals. - It would be appropriate to vary and differentiate the amount of information disclosed depending on the trade size and complexity, client sophistication, etc., and this is not feasible in cases where expediency in trading is required. As a result, this firm expressed concern that this will hinder the provision of optimal trading opportunities to clients. - Upfront disclosure alone should be sufficient. Upfront disclosures of pre-hedging practices without an objection from the client should amount to consent. If the requirements for consent are not practically manageable, it could result in trade latency, and affect the smooth execution of client transactions as well as liquidity. Respondents indicated that, except for cases where dealers individually ask clients for their explicit consent at their discretion, they believe a better and more practical approach would be to allow the dealer to obtain consent on an opt-out basis, disclosing the outline of the pre-hedging activities on the dealer's website through upfront disclosure, and, provided that the content of said disclosures is sufficient, allowing for clients to opt-out as necessary.

B4.	**The dealer should implement appropriate compliance and supervisory arrangements for pre-hedging including (i) supervisory systems and reviews; and (ii) Trade and communications monitoring and surveillance**	
Post-trade reviews		
22	Should stand-alone post-trade reviews be conducted for prehedging? 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?	The JSDA received the following comments from member firms: - Post-trade reviews could help understand whether the pre-hedging was for risk management purposes and also be considered useful for oversight. However, implementing such reviews in practice is challenging and requires careful discussion. Additionally, while the reviews can be used to explain to clients, disclosures to clients should be made only when necessary (e.g., upon client request) and should be flexible. - Based on general monitoring practices, conducting post-trade reviews for each transaction to supervise pre-hedging can improve oversight and meet client demand. However, reviewing every single transaction can reduce the efficiency of risk management and should be avoided. Based on a risk-based approach, monitoring should focus on types of transactions where pre-hedging is likely to occur (e.g., large trades relative to market liquidity). Although this would depend ultimately on the definition of at what point in time conversations with clients may be construed as subject to pre-hedging rules, if the scope of conversations with clients subject to the pre-hedging rules is expanded, the efficiency of risk management may be negatively impacted and, at the same time, it may pose as a potential restriction on sales communications with clients, affecting the provision of products and services to clients at fair and appropriate prices. - It can be challenging to implement independent post-trade reviews solely for pre-hedging. The results of pre-hedging would depend on various factors such as transaction size, product type, and market conditions, making it impossible to compare cases with and without pre-hedging. Additionally, measuring the effects of pre-hedging (such as the degree of improvement in transaction conditions or impact on the market) and accurately analyzing whether it was objectively good or bad is practically difficult. Therefore, it is questionable whether an independent post-trade review for every transaction is feasible. Furthermore, if such review is required, careful discussion is necessary to determine exactly what supervisors and clients should evaluate.
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 changes to the dealer's business risk profile.**	
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?	The JSDA received comments from member firms noting that given the difficulty to differentiate between inventory management and pre-hedging to begin with, they do not find this reasonable from a cost-benefit perspective. - One member firm added that given that potential conflicts of interest can arise in providing financial services for various transactions and counterparties, it is an important obligation for dealers to ensure the management of potential conflicts of interest, and as such it is unnecessary and unrealistic to also establish specific types of controls solely for pre-hedging; rather, such controls should be incorporated into broader policies regarding conflicts of interest and market integrity. - (As a comment for Q15 Trade-by-Trade Disclosure, Q17 Post-Trade Disclosure, Q21 Explicit Prior Consent, Q23 Differentiation between Pre-Hedging and Inventory Management, and Q24 Records) another member firm argued that managing pre-hedging practices for each individual transaction per each individual client (as well as keeping records and conducting monitoring and surveillance of said disclosure) places too great a burden on dealers. It was their view that the costs of establishing systems and personnel required for such new procedures are ultimately passed on to clients as transaction costs or embedded in the transaction price. Given that this is not necessarily in the best interest of clients, this member firm expressed its dissent with the said proposals.

B6.	**The dealer should maintain adequate records of pre-hedging to facilitate oversight, monitoring and surveillance.**	
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?	The JSDA received different levels of detail with respect to records for pre-hedging activity from its member firms, with respondents noting that thorough and careful discussions are necessary for record-keeping requirements. In particular: - One member firm noted that, although they believe pre-hedging must be traceable to client transactions, it is challenging to do so for all transactions. Therefore, thorough and careful discussions are needed regarding the identification and record-keeping of pre-hedging activities. They added that, following these discussions, it is desirable for each firm to consider and establish the necessary management and supervisory measures in their actual operations. - Another member firm noted that the following information could be considered necessary to record for pre-hedging. However, they also noted that pre-hedging transactions can be conducted on a portfolio basis and may not involve the same financial instruments, making identification difficult. Therefore, careful and thorough discussions are needed regarding record-keeping. (1)Information that can identify the potential trade subject to pre-hedging when a request for quote is received from a client, e.g. product name, code, delivery month/issue number, buy/sell, quantity, etc. (2)Timestamp when the request was received (3)Details of the trade (including the flags connecting the pre-hedge trade with the trade details from (1)) (4)Market information for the period during which pre-hedge was undertaken They also indicated that the actual preparation of the above information and operation of the system would place a considerable burden on front-end divisions and system development of dealers, and as such, monitoring and surveillance of pre-hedging should be limited to what is realistically possible. (As a comment for Q15 Trade-by-Trade Disclosure, Q17 Post-Trade Disclosure, Q21 Explicit Prior Consent, Q23 Differentiation between Pre-Hedging and Inventory Management, and Q24 Records) They also argued that managing pre-hedging practices for each individual transaction per each individual client (as well as keeping records and conducting monitoring and surveillance of said disclosure) places too great a burden on dealers. It was their view that the costs of establishing systems and personnel required for such new procedures are ultimately passed on to clients as transaction costs or embedded in the transaction price. Given that this is not necessarily in the best interest of clients, this member firm expressed its dissent with the said proposals. - Another member firm indicated that dealers have a regulatory obligation to prepare and preserve accurate records of their business activities. Consequently, they argue that current regulatory requirements for creating and maintaining records already cover records related to their business activities, including pre-hedging. Pre-hedging can be conducted on a portfolio basis and may not always involve the same financial instruments, making identification challenging. As such, they posit that if it becomes mandatory to identify and record pre-hedging activities for supervision and monitoring, dealers might refrain from conducting pre-hedging transactions that would otherwise have been in the best interest of clients, potentially impairing market functionality. While it is practically difficult to identify and conduct post-trade reviews for all pre-hedging transactions, they propose that a risk-based approach, such as conducting post-trade reviews using existing records for transactions above a certain size, would be considered more realistic. In any event, they underline that thorough discussions and consideration are necessary regarding record-keeping.

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.	A JSDA member firm indicated that while they understand IOSCO's concerns regarding the lack of globally consistent industry codes or standards applicable to all asset classes, existent industry codes have been developed in consultation with regulators and industry participants, making them more meaningful as they are not a one-size-fits-all approach but are applicable to specific markets. As such, the member firm argued that existing industry standards should serve as the basis for discussing the governance framework for pre-hedging; attention should be paid not to adversely affect the standards and practices already outlined in the industry standards.