ASIC's new guidance on pre-hedging

What banks and clients utilising derivatives can learn

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The Australian Securities and Investment Commission (ASIC) has released guidance clarifying its expectations in relation to a bank, or other intermediary, pre-hedging derivative exposures. This article explains what is best practice, going forward.

In summary:

- **Pre-hedging is not a dirty (hyphenated) word**
  There is an understanding in ASIC's guidance that banks and intermediaries will enter into pre-hedging in relation to derivative transactions.
- **Disclosure, disclosure, disclosure**
  The guidance suggests that it is incumbent on the bank or intermediary to ensure that the client is aware of the nature and risk of any pre-hedging activities that it intends to take.
- **Review and reflect**
  While it is not enough to have robust internal protocols that manage conflicts of interest, banks and intermediaries should review complex transactions after the fact and assess how they did.
- **Market mover?**
  While broadly in line with the recommended practices in jurisdictions such as the US and Europe, ASIC's guidance appears to go further than existing international guidance, which may signal an international change.

What is pre-hedging: Profiteering or sensible risk management?

Pre-hedging refers to the practice where, prior to a bank, or other intermediary, executing a derivative transaction with a client, the bank trades in the market to establish part of its hedge position in order to reduce its risk associated with the underlying transaction and enable it to offer a more favourable spread or price to the customer.

While the concept of pre-hedging has sometimes been confused with 'front-running'—a term which describes when a bank (or other intermediary), trades in the market on its own behalf ahead of executing an order as agent for its client so as to obtain a commercial benefit for itself—pre-hedging is not frontrunning. Rather, it is an important risk management tool for banks and is a legitimate and necessary, strategy, particularly for larger and more complicated transactions. Pre-hedging transactions can result in lower execution spreads for clients and less market volatility, as it enables banks to spread their hedging trades over a longer period.

In recent times, however, pre-hedging has come under the regulatory microscope with a number of regulators concerned with how best to protect clients and foster market transparency.

Like much else, it is all about when you use it, how you use it and what you use it for.

What prompted new guidance?

Although regulators across the globe have been looking into pre-hedging, the timing of the new guidance from the Australian Securities and Investments Commission (ASIC) aligns with the recent settlement resulting from it having commenced civil proceedings against Westpac Banking Corporation in 2021.

In these proceedings, ASIC alleged that Westpac engaged in insider trading and statutory unconscionable conduct, and breached its Australian Financial Services Licence (AFSL), in connection with its pre-hedging ahead of an interest rate swap transaction with a consortium of bidders (the consortium) for the majority stake in electricity provider Ausgrid. Allens acted for Westpac in the proceedings.

The possibility that ASIC might consider pre-hedging to amount to insider trading raised questions within the industry about whether it was ever permissible on material transactions. Prior to the commencement of ASIC's case, the widely-held market view was that pre-hedging transactions would *not* amount to insider trading on the basis that such transactions would fall into the “own intentions or activities “exception in sections 1043H-J of the Corporations Act.

This exception permits trading in financial products where the trading person or entity is aware that it has entered, or will enter, into transactions or agreements in relation to financial products with another party. Applying this exception to pre-hedging practices, a bank would not be engaging in insider trading if it entered into derivative transactions with third parties, even though it had knowledge of its own intention to enter into the underlying derivative transaction with its client.

Under the terms of the settlement, ASIC withdrew the insider trading claim, and Westpac admitted to one count of unconscionable conduct and breaches of its AFS license. On 31 January 2024, the Federal Court ordered Westpac to pay a $1.8 million penalty and costs. The unconscionability admission centred around the extent to which it had disclosed its intention to pre-hedge the transaction with the consortium, with the bank admitting that it had not provided “clear and full disclosure about the extent of its planned pre-hedging”.

Does ASIC view pre-hedging as insider trading or illegal or unconscionable activity?

Following its announcement of the settlement with Westpac, ASIC has published a letter to the CEOs of market intermediaries operating in Australia, setting out its expectations in relation to pre-hedging. In the guidance, the regulator acknowledges that “pre-hedging has a role in markets, including in the management of market intermediaries' risk associated with anticipated client orders, and may assist in liquidity provision and execution for clients”.

This tacit acknowledgment from ASIC that pre-hedging is not, in and of itself, illegal or unconscionable allows many market participants to breathe a sigh of relief. While it has not made any statements to this effect, ASIC's withdrawal of its insider trading case against Westpac and publication of the CEO letter may indicate its acceptance of the application of the “own intentions or activities” exception to pre-hedging transactions generally.

While ASIC has given its approval to the concept of pre-hedging generally, the CEO letter clearly sets out its high expectations in relation to pre-hedging practices and protocols, noting that failure to live up to these standards can be unfair and unconscionable.

What are ASIC's expectations for pre-hedging?

ASIC's guidance in relation to pre-hedging centres around establishing adequate arrangements for managing conflicts of interest and market abuse. Specifically, it expects market intermediaries undertaking pre-hedging to:

- have documented policies and procedures to ensure compliance with the law, informed by consideration of the circumstances, when pre-hedging may help to achieve the best overall outcome for clients
- provide effective disclosure to clients of the intermediary's pre-hedging practices in a transparent manner
- obtain explicit client consent before each transaction (where practical), by setting out clear expectations of what pre-hedging is intended to achieve and potential risks such as adverse impact
- monitor execution and client outcomes, and seek to minimise the market impact of pre-hedging
- adequately manage conflicts of interest arising in relation to pre-hedging
- have robust risk and compliance controls to provide effective governance and supervisory oversight of pre-hedging activity
- record key details of pre-hedging—including the process and team members involved—to enhance the monitoring practice, and
- undertake post-trade reviews of the quality of execution for large transactions, which is to be performed by independent team members.

ASIC has suggested the following as best practice:

- obtaining 'transaction level' consent for each trade—as opposed to broad disclosure and consent clauses in umbrella terms and conditions
- providing post-trade disclosure to clients, such as reporting how the pre-hedging was executed and how it benefited (or otherwise impacted) the client, and

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- undertaking post-transaction reviews, and recording key details of pre-hedging for each transaction—including the process, the team members involved and the client outcome.

Like all guidance from ASIC, this is not necessarily determinative, as the ultimate decision will lie with a court. However, this provides some indication of the types of factors that the regulator will take into account as part of its investigations when determining whether or not to commence proceedings or otherwise take punitive actions.

Does this align with the rest of the world?

Pre-hedging is not unique to Australia—a number of other national regulators have been grappling with this issue, and whether or not to provide greater guidance or increased regulation. While ASIC has sought to harmonise its guidance with international standards such as the FX Global Code, and standards of foreign regulators such as the International Organization of Securities Commissions, the European Securities and Markets Authority and the Financial Markets Standard Board (FMSB), those regulators are still going through the process of determining exactly what new guidance or regulations could or should look like. Therefore, ASIC's guidance is one of the first to be formalised, albeit only through the letter to CEOs, and not via a formal regulatory guide or determination.

What's next?

These best practices ASIC suggests are not specifically contemplated by the FMSB's *Standard for the execution of Large Trades in FICC markets* or the FX Global Code. We expect that, as other regulators start publishing guidance or regulations and international work progresses, ASIC may supplement its guidance. FS

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