Guidance on Pre-Hedging

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Recently there has been considerable industry discussion about pre-hedging in the Australian market. Pre-hedging is the Dealer acting as principal in accepting the market risk that the Client is wishing to avoid associated with one or more anticipated Client orders. It is intended to benefit the Client in connection with such orders and any resulting transactions. The benefits of pre-hedging are directed to the interests of the Client and it is important that this market practice is maintained to control risk and minimise costs, such as when a Client is issuing securities.

Since December 2018, AFMA has provided guidance to the market on pre-hedging related to reference price transactions in the form of the AFMA Swaps Reference Price Transaction Guidelines.

Key points to bear in mind are that:

- Dealers may hedge for such purposes and in a manner that is not intended to disadvantage the Client.
- Dealers should communicate their hedging practices to their Clients in a clear manner meant to enable Clients to understand their intentions and actions in the market.
- Dealers should ensure that the Client is aware of the key mechanics of RPTs.
- Dealers should ensure that the sole intention behind their hedging is risk mitigation.
- The hedging must be treated as confidential and must not be disclosed externally, except as required by law.
- Internal disclosure must not result in another part of the Dealer firm profiting inappropriately.

The AFMA Swaps Reference Price Transaction Guidelines are based on and are consistent with the principles in the globally recognised FICC Market Standards Board (FMSB) *Reference Price Transactions standard for the Fixed Income market*. Corresponding guidance for pre-hedging associated with debt capital market primary issuance is also set out in the AFMA DCM Guidelines presently out for public consultation.

The FMSB also recently published the *Standard for the execution of Large Trades in FICC markets*, which in relation to Large Trades sets out where pre-hedging may be undertaken where:

- the dealer legitimately expects to take on market risk and the pre-hedging is undertaken at the dealer's own risk;
- the trading activity is reasonable relative to the size and nature of the anticipated transaction;
- it aims to minimise the impact of the activity on the market; and
- it is designed to benefit the client and not executed in a manner that is meant to disadvantage the client.

The guidance available to the Australian market is clear and consistent on pre-hedging, particularly with regard to it being undertaken in the best interests of the Client.