

White Collar Defense and Investigations

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CFTC Enforcement Action Shows a Sharp Focus on Pre-Hedging Disclosures

On April 25, 2023, in *In re Mizuho Capital Markets LLC*, CFTC No. 23-24, the Commodity Futures Trading Commission (CFTC) issued an enforcement settlement order suggesting potentially heightened disclosure requirements for swap dealers “pre-hedging” positions expected to result from a contemplated transaction. The order suggests that a swap dealer’s failure to disclose certain information to its anticipated counterparty before engaging in pre-hedging could be deemed to violate external business conduct rules.

In re Mizuho Capital Markets LLC

According to the CFTC’s order, Mizuho Capital Markets LLC (Mizuho) was engaged in FX forward transactions that required the parties to first agree on a spot exchange rate.¹ When the client called the Mizuho salesperson to agree on a spot exchange rate and execute the transaction, the Mizuho salesperson would notify a Mizuho trader, and the trader would start hedging Mizuho’s anticipated exposure, often trading through multiple price levels before the Mizuho salesperson provided the spot exchange rate to the client and executed the trade.² Although 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, Mizuho did not specify to clients that it might engage in trading in the “minutes or seconds” before execution.³ The CFTC found that trading FX spot in this manner allowed Mizuho to hedge its spot exposure at a more favorable rate than would have otherwise been available, and resulted in counterparties obtaining less favorable 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 (the CEA) 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.”⁴ The CFTC explained that because Mizuho had an incentive to trade in the minutes or

¹ *Id.* at 2.

² *Id.*

³ Later, Mizuho added to its disclosure language that it “will always endeavor to avoid unreasonable impact on the market” and will “appropriately manage any possible conflicts of interest that are anticipated from the information it acquires through relevant transactions.” The order, however, charged violations both before and after its disclosure language was changed. *Id.*

⁴ *Mizuho*, at 4.

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seconds before the transaction to obtain a more favorable 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.⁵ 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.

Arguable Expansion of Disclosure Requirements

The *Mizuho* order could be viewed as giving an expansive interpretation to CFTC Regulation §23.431(a)(3)(ii). That provision requires disclosure of “compensation or other incentives” received from a third party, and the CFTC’s corresponding guidance addresses disclosures of “incentives paid to swap dealers ... by various market infrastructures [derivatives clearing organizations (DCOs), swap data repositories (SDRs), designated contract markets (DCMs) and swap execution facilities (SEFs)],” such as “fee rebates, discounts, and revenue and profit sharing.”⁶ The

facts alleged in *Mizuho* are unrelated to benefits from a third party. Rather, the undisclosed benefit Mizuho allegedly obtained came from its pre-hedging activities. In the wake of *Mizuho*, it is unclear what, if any, limits the CFTC believes apply to this provision.

Looking Forward

Although the CFTC may have muddied the scope of §23.431(a)(3)(ii), the *Mizuho* settlement gives an indication of potentially sufficient disclosures in this context, as it notes that Mizuho remediated by disclosing that pre-hedging may occur in the seconds or minutes before, during or after the execution of a trade, and that pre-hedging may negatively impact price or liquidity.⁷ Swap dealers should review their disclosures to make sure they are sufficiently specific to meet the CFTC’s expectations, and ensure that personnel are adequately trained to render the disclosures as applicable.

⁵ *Id.*

⁶ Business Conduct Standards for Swap Dealers and Major Swap Participants With Counterparties, 77 Fed. Reg. 9734, 9766 (Feb. 17, 2012).

⁷ *Mizuho*, at 6.