



U.S. COMMODITY FUTURES TRADING COMMISSION

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Division of Swap Dealer and
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CFTC Letter No. 13-39
No-Action
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Division of Swap Dealer and Intermediary Oversight

Re: Time Limited Relief for Swap Dealers in Connection with Foreign Exchange Intermediated Prime Brokerage Arrangements

Ladies and Gentlemen:

This letter is in response to requests for relief from market participants to the Division of Swap Dealer and Intermediary Oversight (“**Division**”) of the Commodity Futures Trading Commission (“**Commission**”) regarding the application of certain business conduct standards for swap dealers (“**SDs**”) with counterparties¹ in the context of “intermediated” prime brokerage arrangements² relating to certain foreign exchange transactions. Market participants have requested that the Division provide no-action relief to SDs from certain obligations under the External Business Conduct Standards described below for certain transactions executed in accordance with intermediated prime brokerage arrangements where the SD has allocated one or more of such obligations under the External Business Conduct Standards to an agent intermediary that is registered with the Commission as an introducing broker (“**IB**”) or futures commission merchant (“**FCM**”).

Subject to the conditions described herein, the relief provided in this letter applies to (i) foreign exchange transactions that are swaps³ (“**Swaps on FX**”), other than such swaps subject to the clearing requirement of section 2(h)(1)(A) of the Act and part 50 of the Commission’s regulations, if any, and (ii) physically-settled foreign exchange forwards and swap agreements that have been exempted from the definition of swap by the U.S. Department of the Treasury⁴ (“**Exempt FX Transactions**”) and together with Swaps on FX, the “**Covered Transactions**”).

¹ See 17 CFR §§ 23.400-23.451 and Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties, 77 FR 9734, Feb. 17, 2012 (hereinafter, the “**External Business Conduct Standards**”).

² As more fully described infra in the “Summary of Request for Relief.”

³ Swaps are defined in Section 1a(47) of the Commodity Exchange Act (the “**Act**” or “**CEA**”) and Commission regulation 1.3(xxx), 17 CFR 1.3(xxx).

⁴ Determination of Foreign Exchange Swaps and Foreign Exchange Forwards Under the Commodity Exchange Act, 77 Fed. Reg. 69694 (Nov. 20, 2012) (hereinafter, the “**Treasury Determination**”).

Applicable Regulatory Requirements

Section 4s(h) of the CEA provides the Commission with both mandatory and discretionary rulemaking authority to impose business conduct standards on SDs and major swap participants in their dealings with counterparties, including Special Entities. Pursuant to section 4s(h) of the CEA, on December 22, 2010, the Commission published in the Federal Register proposed Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties as subpart H of part 23 of the Commission's regulations.⁵ There was a 60-day period for the public to comment on the proposing release. On May 4, 2011, the Commission published in the Federal Register a notice to re-open the public comment period for an additional 30 days, which ended on June 3, 2011.⁶ On February 17, 2012, the Commission published in the Federal Register final business conduct rules for SDs and major swap participants as subpart H of part 23.⁷ The initial compliance date for the External Business Conduct Standards was the later of 180 days after the effective date of the External Business Conduct Standards or "the date on which swap dealers or major swap participants are required to apply for registration pursuant to Commission rule 3.10."⁸ The Commission subsequently postponed the compliance date for a number of the provisions of the External Business Conduct Standards until May 1, 2013.⁹ Following such compliance date, SDs and MSPs are required to comply with the External Business Conduct Standards when entering into Covered Transactions with non-SD, non-MSP counterparties.

In the adopting release for the External Business Conduct Standards, the Commission recognized that counterparties may enter into swaps through a prime brokerage arrangement. With respect to compliance with the External Business Conduct Standards in transactions entered into through a prime brokerage arrangement, the Commission stated in the adopting release that "[s]wap dealers and major swap participants will be permitted to arrange with third parties, such as the counterparty's prime broker, a method of providing disclosure or verifying that a Special

⁵ Business Conduct Standards for Swap Dealers and Major Swap Participants With Counterparties, 75 FR 80638 (proposed Dec. 22, 2010).

⁶ Reopening and Extension of Comment Periods for Rulemakings Implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act, 75 FR 25274 (May 4, 2011).

⁷ See *supra* note 1.

⁸ External Business Conduct Standards at 9734.

⁹ In September 2012, the Commission changed the compliance date of §§ 23.402; 23.410(c); 23.430; 23.431(a)–(c); 23.432; 23.434(a)(2), (b), and (c); 23.440; and 23.450 to January 1, 2013. See Confirmation, Portfolio Reconciliation, Portfolio Compression, and Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants, 77 FR 55904, 55942 (Sept. 11, 2012). The Commission later changed the compliance date for these provisions to May 1, 2013. See Business Conduct and Documentation Requirements for Swap Dealers and Major Swap Participants; Extension of Compliance Date, 78 FR 17, 20 (Jan. 2, 2013).

Entity has an independent representative to satisfy its obligations under the rules.”¹⁰ However, the Commission made clear that “the swap dealer or major swap participant [that offers to enter into a swap with the counterparty] will remain responsible for compliance with the rules.”¹¹

With respect to the Exempt FX Transactions, pursuant to Section 1a(47)(E) of the CEA,¹² the Secretary of the Treasury (“Secretary”) is vested with the authority to determine whether foreign exchange swaps and foreign exchange forwards should be regulated as swaps under the CEA, provided that the Secretary makes a written determination satisfying certain criteria specified in CEA Section 1b. On November 16, 2012, the Secretary issued a written determination that foreign exchange swaps and forwards should not be regulated as swaps under the CEA.¹³ Nonetheless, CEA Section 1a(47)(E)(iv) provides that, notwithstanding the Secretary’s written determination, “any party to a foreign exchange swap or forward that is a swap dealer or major swap participant shall conform to the business conduct standards contained in section 4s(h) [of the CEA].”¹⁴ Thus, SDs and major swap participants were required to comply with the External Business Conduct Standards with respect to Exempt FX Transactions, including those for which the compliance date is May 1, 2013.

On April 30, 2013, the Division issued a no-action letter that recognized the difficulty of complying with the External Business Conduct Standards under long-standing prime brokerage arrangements (the “**Prime Brokerage Letter**”).¹⁵ In response to the request of participants in such arrangements, the Division provided no-action relief to certain SDs from compliance with the obligations of the SD under Commission regulations §§ 23.402(b)-(f) (Know your counterparty, True name and owner, Reasonable reliance on representations, Manner of disclosure and Disclosures in a standard format, respectively), 23.430 (Verification of counterparty eligibility), 23.431 (Disclosures of material information), 23.432(b) (Clearing disclosures for swaps not required to be cleared—right to clearing), 23.434 (Recommendations to counterparties--institutional suitability), 23.440 (Requirements for swap dealers acting as advisors to Special Entities), 23.450 (Requirements for swap dealers and major swap participants acting as counterparties to Special Entities), and 23.451 (Political contributions by certain swap dealers) with respect to a Covered Transaction with a counterparty executed under a prime brokerage arrangement to the extent any such obligations have been allocated to another SD and such other SD has accepted such allocation, subject to certain conditions regarding the form of the prime brokerage arrangement, notice to the counterparty, and documentation of the allocation. Subsequent to the issuance of the Prime Brokerage Letter, market participants have brought to the attention of the Division the difficulty of complying with the External Business

¹⁰ External Business Conduct Standards at 9741.

¹¹ *Id.* at 9741.

¹² 7 U.S.C. 1a(47)(E).

¹³ See Treasury Determination, *supra* note 2.

¹⁴ Additionally, foreign exchange swaps and forwards are subject to reporting obligations, pursuant to Section 1a(47)(E)(iii) of the CEA, 7 U.S.C. § 1a(47)(E)(iii).

¹⁵ See CFTC Staff Letter No. 13-11, April 30, 2013.

<http://www.cftc.gov/ucm/groups/public/@lrllettergeneral/documents/letter/13-11.pdf>.

Conduct Standards under similarly long-standing intermediated prime brokerage arrangements with respect to Covered Transactions. Specifically, the requesting market participants have argued that the basic form of prime brokerage described in the Prime Brokerage Letter is not the only form of prime brokerage transactions that should qualify for the relief provided therein.

Description of FX Intermediated Prime Brokerage Arrangements

As explained by market participants, “intermediated” prime brokerage arrangements in Covered Transactions also are prevalent in the market. As described to the Division, intermediated prime brokerage arrangements currently operate in many forms, but each shares in common the presence of an intermediary (the “**FX intermediary**”) that acts as an agent for a prime broker that intermediates between a counterparty and an executing dealer in a Covered Transaction, providing the counterparty with the benefit of anonymity and access to a far larger pool of possible executing dealers, leading to better pricing and control of the knowledge of the counterparty’s market position. FX intermediaries, while ostensibly acting as agents for the prime broker, provide value to counterparties as brokers with superior market knowledge and more extensive access to liquidity through their professional expertise and extensive relationships with dealers and other liquidity providers. As explained to Division staff, this knowledge, access and expertise would be impracticable for a counterparty to develop and maintain on its own. As support for their argument, the requesting market participants have provided Division staff with numerous written testimonials from buy-side market participants, including asset managers and corporates, confirming that the FX intermediaries:

- Preserve anonymity of the counterparties’ trading strategies and positions;
- Provide objective, unbiased market advice because the intermediaries do not operate proprietary trading books;
- Have knowledge and expertise in the foreign exchange market that works to the advantage of counterparties when negotiating the terms of transactions, including knowledge of the strengths of dealers in certain types of transactions; and
- Have access to a larger pool of liquidity than is conveniently available to the counterparties to obtain multiple real-time prices, increasing the opportunity of obtaining transparent and verifiable best execution.

As described by market participants, intermediated prime brokerage transactions for the purposes of this letter always include a market participant who is not a SD (the “counterparty”) that opens an account (or otherwise enters into an arrangement) with a prime broker that is an SD. Prior to approving and entering into the prime brokerage arrangement, the prime broker will conduct due diligence and know-your customer reviews with respect to the counterparty.

In the most basic form of prime brokerage prevalent in the market for Covered Transactions, the prime broker may grant limited agency powers to the counterparty, enabling the counterparty, as an agent for the prime broker, to negotiate Covered Transactions with a number of approved executing dealers, subject to specified limits and parameters. However, the prime broker may also grant such limited agency powers to an FX intermediary, and provide such intermediary with a list of the prime broker’s approved counterparties and executing

dealers. In such case, the FX intermediary is then free to establish relationships with one or more of the approved counterparties and executing dealers and to negotiate Covered Transactions for such counterparties with one or more of such executing dealers, as a limited agent of the prime broker.

With this information, an FX intermediary, on behalf of a counterparty or an asset manager or other representative of a counterparty, will seek bids or offers for a desired Covered Transaction from one or more of the approved executing dealers within the parameters established by the prime broker for the counterparty and executing dealers. Once the FX intermediary has negotiated the terms of one or more Covered Transactions between a counterparty and one or more executing dealers, the FX intermediary will provide a notice of the terms of the Covered Transaction to the prime broker.

As long as the Covered Transaction is with an approved counterparty and an approved executing dealer, the terms are within the parameters established by the prime broker, and other conditions that may have been agreed among the parties are satisfied, upon receiving notice of the negotiated terms the prime broker will be obligated, either by contract or custom, to face the counterparty in a Covered Transaction with the same terms agreed upon by the executing dealer and counterparty (as negotiated by the FX intermediary), and to enter into a second Covered Transaction with equal but opposite terms with the executing dealer. As explained by the requesting market participants, the counterparty and the executing dealers need not know each other's identities, preserving the anonymity of the counterparty and keeping its market position confidential. The FX intermediary never acts as principal to a trade and has no proprietary trading book, and thus does not compete with the counterparty or the executing dealers. The FX intermediary is compensated by the prime broker for whom it acts as agent under any one of a variety of compensation arrangement, including being remunerated on the basis of a spread on the Covered Transaction or on a fee basis.

In addition to the foregoing form of intermediated prime brokerage in Covered Transactions, many others have been described to the Division. For example, the FX intermediary may act for one prime broker while the executing dealer may use a separate prime broker that has a relationship with the first, allowing the FX intermediary to negotiate a transaction for a counterparty with an executing dealer that does not have a direct relationship with the first prime broker. This type of intermediated trade is booked as a transaction between the counterparty and its prime broker, a transaction between such prime broker and the executing dealer's prime broker, and another transaction between the executing dealer's prime broker and the executing dealer.

Summary of Request for Relief

Despite the many forms of FX intermediated prime brokerage arrangements, it is only the FX intermediary that communicates with the counterparty prior to the time terms of a Covered Transaction are agreed. Thus, market participants have represented to the Division that it would be impracticable for prime brokers and executing dealers that are SDs to fully comply with the External Business Conduct Standards in such intermediated arrangements, as each entity has

access to different information at different points of time, and only the FX intermediary is in communication with the counterparty prior to determining the final terms of the transaction.

Market participants have represented that only the prime broker usually maintains detailed credit and other portfolio information regarding the counterparty. On the other hand, the executing dealer will often not know the identity of the underlying counterparty in an intermediated transaction. It is the FX intermediary that represents the counterparty in negotiation of the terms of a Covered Transaction with the executing dealer, providing the counterparty with its desired anonymity. Thus, market participants argue that the prime broker is in the best position to take responsibility for compliance with the External Business Conduct Standards that relate to the general relationship between the SD and its counterparty, such as “know-your-counterparty” obligations under § 23.402, while the FX intermediary, but not the prime broker, will have access to timely trade information and information about the inherent risks relating to the transaction. As a result, market participants argue that the FX intermediary is in the best position to take responsibility for compliance with transaction-specific External Business Conduct Standards, such as providing the pre-trade mid-market quote and risk disclosures under § 23.431.

To facilitate compliance with the External Business Conduct Standards in the context of intermediated prime brokerage arrangements in Covered Transactions, market participants have proposed that SDs be permitted to allocate responsibility for compliance with one or more business conduct obligations between themselves and an FX intermediary that is either an introducing broker (“**IB**”) or futures commission merchant (“**FCM**”) registered with the Commission, on the same terms as SDs are permitted to allocate such obligations between themselves under the Prime Brokerage Letter. The Division notes that there is no request to relieve SDs from, or permit an allocation of, the anti-fraud, fair dealing, confidentiality, and other general conduct requirements under the External Business Conduct Standards, which would be complied with by each of the SD acting as prime broker, an SD acting as executing dealer, and an FX intermediary (as required by the conditions of this letter) as applicable to their activities.

Market participants have represented to the Division that unless SDs are permitted to allocate compliance with certain External Business Conduct Standards between the prime broker and the FX intermediary, it will be impossible to continue existing intermediated prime brokerage arrangements or, at a minimum, such arrangements will be significantly impacted. Requesters argue that in order to comply with the External Business Conduct Standards, trading that currently occurs through intermediated prime brokerage arrangements would need to occur under classic prime brokerage arrangements involving only prime brokers and executing dealers, or bilaterally between the executing dealer and the counterparty in full compliance with the External Business Conduct Standards. Since many executing dealers do not, and, due to risk limits, will not, have bilateral contractual relationships covering compliance with the External Business Conduct Standards with many counterparties, they would need to negotiate and enter into the necessary documentation or forego transacting with prime brokerage customers, which would, if a significant number of executing dealers did forego such transactions, decrease price competition and, at a minimum, disrupt trading for a significant period of time.

In sum, counterparties that currently depend on intermediated prime brokerage arrangements to meet their needs fear that requiring compliance with the totality of the business conduct obligations by prime brokers will eliminate or severely curtail their ability to seek prices from as wide a range of executing dealers and destroy their anonymity, leaving them with only their prime broker(s) as potential counterparties. Indeed, the Division has been informed by requesting market participants that some FX intermediaries have already been contacted by prime brokers informing them that the prime broker will no longer allow such FX intermediaries to intermediate Covered Transactions. Counterparties that use the services of FX intermediaries recognize that the loss of FX intermediaries may lead to higher prices for the counterparty. Market participants argue that as a result of the foregoing, the market will suffer reduced liquidity through a sudden drop in the number of participants in the markets, the management of counterparty credit risk will be more difficult for non-SD market participants, and such non-SD market participants will experience decreased collateral efficiency.

Division No-Action Position

Based on the representations made by market participants, the Division believes that no-action relief is warranted with respect to the External Business Conduct Standards as they relate to Covered Transactions executed under intermediated prime brokerage arrangements where the prime broker is an SD and the FX intermediary is either an IB or FCM. However, the Division has determined to limit the business conduct obligations that may be allocated between an SD and an FX intermediary, as compared to those subject to allocation between SDs under the Prime Brokerage Letter. Thus, the Division is not granting relief to an SD acting as prime broker with respect to its obligations under §§ 23.402(b) and (c) (Know your counterparty, and True name and owner, respectively) or 23.430 (Verification of counterparty eligibility). These obligations must remain with the prime broker that is an SD. The remainder of the business conduct obligations subject to allocation remain the same as those in the Prime Brokerage Letter.

Accordingly, the Division will not recommend that the Commission commence an enforcement action against a SD for failure to comply with the obligations of the SD under §§ 23.402(d)-(f) (Reasonable reliance on representations, Manner of disclosure, and Disclosures in a standard format, respectively), 23.431 (Disclosures of material information), 23.432(b) (Clearing disclosures for swaps not required to be cleared—right to clearing), 23.434 (Recommendations to counterparties--institutional suitability), 23.440 (Requirements for swap dealers acting as advisors to Special Entities), 23.450 (Requirements for swap dealers and major swap participants acting as counterparties to Special Entities), and 23.451 (Political contributions by certain swap dealers) (the “**apportionable business conduct obligations**”) with respect to a Covered Transaction with a counterparty executed under an intermediated prime brokerage arrangement to the extent any such obligations have been allocated to an IB or FCM registered as such with the Commission (a “**Registrant Intermediary**”) and such IB or FCM has accepted such allocation, subject to the following conditions:

- (a) The intermediated prime brokerage arrangement meets the following description: An arrangement between or among an SD, a Registrant Intermediary, an executing dealer, and the counterparty evidenced by written agreements pursuant to which:
 - (1) A Registrant Intermediary negotiates and obtains agreement of the counterparty to the material terms and conditions of a Covered Transaction and then the Registrant Intermediary negotiates and obtains agreement of one or more executing dealers to the material terms and conditions of a Covered Transaction (with substantially equal but opposite terms);
 - (2) Upon satisfaction of conditions agreed upon between the SD, one or more executing dealers, the counterparty, and the Registrant Intermediary, the SD (the “**prime broker**”) is required to enter into two Covered Transactions, one with the counterparty and one with the executing dealer (or another prime broker or executing dealer that directly or indirectly enters into a matching Covered Transaction with the executing dealer); and
 - (3) As a result of the foregoing:
 - (i) The prime broker and the counterparty are parties to a Covered Transaction in which all material terms and conditions are substantially identical (other than adjustments attributable to intermediation fees) to the terms and conditions to which the counterparty and the executing dealer previously committed through the Registrant Intermediary; and
 - (ii) The prime broker and the executing dealer (or another prime broker or executing dealer that directly or indirectly enters into a matching Covered Transaction with the executing dealer) are parties to a Covered Transaction with substantially equal but opposite terms and conditions to the Covered Transaction between the prime broker and the counterparty.
- (b) The apportionable business conduct obligations with respect to the counterparty are allocated between the SD and the Registrant Intermediary and no apportionable business conduct obligation is left unallocated between such SD and Registrant Intermediary.
- (c) The counterparty with respect to which apportionable business conduct obligations have been so allocated (or its duly authorized representative) is provided with notice of the apportionable business conduct obligations that have been allocated to the SD and the Registrant Intermediary prior to the time at which any such obligation is required to be performed.
- (d) The allocation of the apportionable business conduct obligations is in writing and includes an agreement by the SD and Registrant Intermediary that:

- (1) Each of the SD and Registrant Intermediary will severally comply with the prohibition on fraud, manipulation, and other abusive practices in accordance with § 23.410, and the duty to communicate with counterparties in a fair and balanced manner in accordance with § 23.433 with respect to their own actions and communications in relation to Covered Transactions executed under an intermediated prime brokerage arrangement;
 - (2) It will perform or otherwise be responsible for each apportionable business conduct obligation it has agreed to be allocated to it to the full extent of such obligation;
 - (3) The SD will not be responsible for the compliance of the Registrant Intermediary with the apportionable business conduct obligations allocated solely to the Registrant Intermediary, including compliance with § 23.433 in relation to the Registrant Intermediary's communications with the counterparty;
 - (4) The Registrant Intermediary will not be responsible for the compliance of the SD with the apportionable business conduct obligations allocated solely to the SD; and
 - (5) The counterparty (or its duly authorized representative) will be provided notice of any expiration or termination of the allocation of apportionable business conduct obligations no later than 30 days prior to such expiration or termination, and the SD and Registrant Intermediary will remain responsible for fulfilling all applicable apportionable business conduct obligations allocated to it until such expiration or termination.
- (e) Each of the SD and the Registrant Intermediary makes and retains a record of the applicable intermediated prime brokerage arrangement, the written allocation of apportionable business conduct obligations, and the delivery of notice of such written allocation to the applicable counterparty (if the obligation to deliver such notice shall have been allocated to it) in accordance with Commission regulation § 23.203 or § 1.31, as applicable, and makes such records available to the Commission upon request.
- (f) The Registrant Intermediary executes in writing an undertaking by which the Registrant Intermediary consents to the jurisdiction of the Commission to investigate and take enforcement action against the Registrant Intermediary or any employee of the Registrant Intermediary engaged in any intermediation of a Covered Transaction described in this letter or the performance of the apportionable business conduct obligations allocated to the Registrant Intermediary in reliance on this letter for any violation of such apportionable business conduct obligations, the CEA or Commission regulations (including §§ 23.410 and 23.433). The Registrant Intermediary must provide each SD and counterparty for which an allocation of apportionable business conduct obligations has been accepted by the Registrant Intermediary with an executed copy of the undertaking (either directly or pursuant to an industry protocol to which the SD and

counterparty have adhered) and maintain the undertaking at its main business office and in accordance with § 1.31.

The Division recognizes that the conditions of the no-action relief described above may require SDs and Registrant Intermediaries to complete new documentation and provide certain notices to qualify for such relief. To allow time for such conditions to be met and to avoid market disruption in the meantime, the Division will not recommend that the Commission commence an enforcement action against a SD for failure to comply with any apportionable business conduct obligations (as defined in this letter) with respect to Covered Transactions until July 19, 2013, provided that such Covered Transactions are conducted under intermediated prime brokerage arrangements of such SD in existence on the date of this letter. Such relief does not apply to Covered Transactions with any counterparty not executed under an intermediated prime brokerage arrangement in existence on the date of this letter. All relief in this letter is time-limited and will end at 12:01 eastern time on the later of the effective date or the compliance date of any final rule or final order providing relief from the External Business Conduct Standards as they relate to Covered Transactions executed under intermediated prime brokerage arrangements, as described in this letter.

This letter, and the positions taken herein, represent the view of the Division only, and do not necessarily represent the position or view of the Commission or of any other office or division of the Commission. The relief issued by this letter does not excuse the affected persons from compliance with any other applicable requirements contained in the CEA or in the Commission's regulations issued thereunder. Specifically, the relief issued by this letter does not relieve any person from an obligation to report a swap or information concerning a swap under part 43 or part 45 of the Commission's regulations. Further, this letter, and the relief contained herein, is based upon the information made available to the Division. Any different or changed material facts or circumstances might render this letter void.

Should you have any questions, please do not hesitate to contact me at (202) 418-5977; Frank Fisanich, Chief Counsel, at (202) 418-5949; or Jason Shafer, Attorney-Advisor, at (202) 418-5097.

Very truly yours,

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