



## U.S. COMMODITY FUTURES TRADING COMMISSION

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Division of Swap Dealer and  
Intermediary Oversight

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CFTC Letter No. 13-11  
No-Action  
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Division of Swap Dealer and Intermediary Oversight

### **Re: Time Limited Relief for Swap Dealers in Connection with 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 counterparties<sup>1</sup> in the context of prime brokerage arrangements relating to swaps and certain foreign exchange transactions. Market participants have requested that the Division provide no-action relief to SDs from some obligations under the External Business Conduct Standards for certain transactions executed in accordance with prime brokerage arrangements where the SD has (i) allocated certain obligations under the External Business Conduct Standards to an executing dealer that is also an SD, or (ii) entered into prime brokerage arrangements with executing dealers that are not SDs.

The relief provided in this letter applies to swaps, as defined in Section 1a(47) of the Commodity Exchange Act (the “Act” or “CEA”) and Commission regulation 1.3(xxx) (other than swaps subject to the clearing requirement of section 2(h)(1)(A) of the Act and part 50 of the Commission’s regulations), and physically-settled foreign exchange forwards and swap agreements that have been exempted from the definition of swap by the U.S. Department of the Treasury<sup>2</sup> (“Exempt FX Transactions” and together with such swaps, the “Covered Transactions”).

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<sup>1</sup> 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”).

<sup>2</sup> 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.<sup>3</sup> 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.<sup>4</sup> 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.<sup>5</sup> 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."<sup>6</sup> The Commission subsequently postponed the compliance date for a number of the provisions of the External Business Conduct Standards until May 1, 2013.<sup>7</sup>

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 Entity has an independent representative to satisfy its obligations under the rules."<sup>8</sup> However,

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<sup>3</sup> Business Conduct Standards for Swap Dealers and Major Swap Participants With Counterparties, 75 FR 80638 (proposed Dec. 22, 2010).

<sup>4</sup> 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).

<sup>5</sup> See *supra* note 1.

<sup>6</sup> External Business Conduct Standards at 9734.

<sup>7</sup> In September 2013, 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).

<sup>8</sup> External Business Conduct Standards at 9741.

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.”<sup>9</sup>

With respect to the Exempt FX Transactions, pursuant to Section 1a(47)(E) of the CEA,<sup>10</sup> 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.<sup>11</sup> 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].”<sup>12</sup> Thus, SDs and major swap participants are 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.

### **Description of Prime Brokerage Arrangements**

As explained by market participants, prime brokerage arrangements in Covered Transactions currently operate in two distinct forms, but each begins with a market participant who is not a SD (the “counterparty”) opening an account (or otherwise entering into an arrangement) with a prime broker that may be 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 first form of prime brokerage, prevalent in the market for Covered Transactions involving foreign exchange, 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 other approved counterparties known as executing dealers, subject to specified limits and parameters.

In the second form of prime brokerage, the counterparty is not granted agency powers, but rather agrees to specified limits and parameters with the prime broker for Covered Transactions that the counterparty will enter into with approved executing dealers, which will subsequently be “given up” to the prime broker. In this respect, the prime broker will also enter into “give-up” agreements with the approved executing dealers in which the executing dealers either agree to negotiate Covered Transactions within specified parameters with the counterparty,

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<sup>9</sup> *Id.* at 9741.

<sup>10</sup> 7 U.S.C. 1a(47)(E).

<sup>11</sup> See Treasury Determination, *supra* note 2.

<sup>12</sup> 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).

who is acting as an agent for the prime broker, or agree to “give-up” Covered Transactions entered with the counterparty to the prime broker.

The counterparty, or an asset manager or other representative of the 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 dealer. Once the counterparty and executing dealer agree on the terms, the counterparty and executing dealer will either provide a notice of the terms to the prime broker (in the first form of prime brokerage) or enter into the Covered Transaction themselves (in the second form).

If the counterparty and executing dealer do not enter into a Covered Transaction themselves, they will provide the prime broker with notice of the terms negotiated. As long as the Covered Transaction is with 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. Once this first Covered Transaction is entered into by the prime broker, the prime broker will enter into a second Covered Transaction with equal but opposite terms with the executing dealer.

If the counterparty and executing dealer enter into a Covered Transaction themselves, and the Covered Transaction falls within the parameters set by the prime broker, the prime broker would be obligated to become a party to the Covered Transaction with the counterparty (or the executing dealer) through a novation. The prime broker will subsequently enter into a second Covered Transaction with the executing dealer (or the counterparty) with equal but opposite terms to the Covered Transaction with the other party.

In either form of prime brokerage, the end result would be two Covered Transactions with equal but opposite terms. One Covered Transaction will be between the prime broker and the counterparty (“Counterparty-PB Transaction”) and the other between the prime broker and the executing dealer (the “ED-PB Transaction”).

A number of market participants have described the benefits of prime brokerage arrangements. They have represented that prime brokerage arrangements (1) increase market liquidity and allow market participants to obtain more favorable pricing from an executing dealer with whom the market participant may not have a credit relationship; (2) permit market participants who are customers of SDs to simplify management of counterparty risk by minimizing the number of firms they face; (3) lower costs for market participants by eliminating the need to enter into extensive trading documentation with each executing dealer with which they want to trade; (4) increase collateral efficiencies by permitting prime brokers to net collateral obligations across all trades for a market participant handled by the prime broker; and (5) decrease operational risk.

### **Summary of Request for Relief**

Market participants have represented to the Division that it would be difficult or impracticable for prime brokers and executing dealers to fully comply with the External Business Conduct Standards as each entity has access to different information at different points of time. They 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 many instances, an asset manager or other representative of the counterparty will negotiate the terms of a Covered Transaction with the executing dealer on behalf of a number of counterparties and allocate the transaction to the counterparties only after the execution of the Counterparty Mirror Transaction. 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.

Conversely, the executing dealer, but not the prime broker, often will have access to timely trade information and information about the inherent risks relating to both the ED-PB Transaction and the Counterparty Mirror Transaction. As a result, market participants argue that the executing dealer (assuming that such dealer is a SD)<sup>13</sup> is in the best position to take responsibility for compliance with External Business Conduct Standards that are transaction specific, 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 prime brokerage arrangements, market participants have proposed that SDs be permitted to allocate responsibility between two SDs for compliance with certain obligations to counterparties under the External Business Conduct Standards. In addition, relief has also been requested for SDs acting as prime brokers from compliance with certain External Business Conduct Standards altogether when an executing dealer is not required to be registered with the Commission as a SD.<sup>14</sup> In such circumstances, the executing dealer is not required to comply with any part of the External Business Conduct Standards and thus has nothing to allocate to a prime broker in return for accepting an allocation of certain obligations of the prime broker. 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 both the SD acting as prime broker and an SD acting as executing dealer as applicable to their activities.

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<sup>13</sup> The External Business Conduct Standards apply only to SDs and major swap participants. *See, e.g.*, § 23.400 and CEA Section 1a(47)(E)(iv).

<sup>14</sup> Not all dealers in the Covered Transactions are required to be registered with the Commission as SDs. For example, dealers in swaps that have not entered into swaps with an aggregate notional amount above a de minimis threshold set by Commission regulations are not required to be registered with the Commission as SDs. *See* 17 CFR § 1.3(gg)(4). In addition, entities that are dealers exclusively in Covered Transactions that are Exempt FX Transactions are not required to register as SDs.

Market participants have represented to the Division that unless SDs are permitted to allocate compliance with the External Business Conduct Standards between the prime broker and the executing dealer, it will be impossible to continue existing prime brokerage arrangements or, at a minimum, such arrangements will be significantly impacted. To comply with the External Business Conduct Standards, trading that currently occurs through prime brokerage arrangements would need to occur 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 addition, the Division understands that counterparties in prime brokerage arrangements may receive price quotes for an Exempt FX Transaction from 20-30 executing dealers or more, and that some counterparties transact in large block sizes that can only be filled by many executing dealers each taking a part of the counterparty's large block trade. For Exempt FX Transactions, many executing dealers may not be SDs registered with the Commission. As non-registered dealers, these executing dealers do not have any obligations under the External Business Conduct Standards, so a prime broker that is a registered SD would bear the entire burden of compliance with such standards. The Commission understands that due to this burden, prime brokers may cease to participate in prime brokerage arrangements with executing dealers that are not registered SDs, eliminating a portion of executing dealers that provide counterparties with competitive pricing. In the market for Exempt FX Transactions, the portion of executing dealers eliminated could be significant.

In sum, counterparties that currently depend on prime brokerage arrangements to meet their needs fear that the implementation of the External Business Conduct Standards will eliminate or severely curtail their ability to seek prices from a wide range of executing dealers, leaving them with only their prime broker(s) as potential counterparties. Indeed, the Division understands that some counterparties have already been contacted by executing dealers informing them that the executing dealer will not trade with the counterparty following the compliance date for the relevant External Business Conduct Standards. Such counterparties recognize that their prime broker(s) will be aware of their limited ability to seek competitive prices, and fear that this may lead to higher prices for the counterparty. In addition, the implementation of the External Business Conduct Standards may cause a large number of executing dealers to be eliminated from the prime brokerage portion of the market for Exempt FX Transactions or to have their ability to transact with a wide range of counterparties significantly curtailed. 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.<sup>15</sup>

### **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 prime brokerage arrangements where the prime broker and the executing dealer are each SDs. 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 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) (collectively, the “apportionable business conduct obligations”) 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 the following conditions:

- (a) The prime brokerage arrangement meets the following description: An arrangement between or among two SDs and the counterparty evidenced by written agreements pursuant to which:
  - (1) With respect to the first type of prime brokerage arrangement:
    - (i) One SD (the “executing dealer”), together with the counterparty, commits to the material terms and conditions of a Covered Transaction;
    - (ii) Upon satisfaction of certain conditions, the second SD (the “prime broker”) is required to enter into two Covered Transactions, one with the counterparty and one with the executing dealer; and
    - (iii) As a result of the foregoing:
      - (A) 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 charged by the prime broker) to the terms and conditions to which the counterparty and the executing dealer previously committed; and

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<sup>15</sup> As support for these representations, a swap industry trade association has represented that approximately 18% of swaps in the credit and interest rate asset classes are executed under prime brokerage arrangements. For the foreign exchange asset class, the percentage of trades that have been represented as executed under prime brokerage arrangements appears to vary widely by currency pair and type of transaction, but ranges from an average of approximately 10% for foreign exchange options to almost 30% for non-deliverable forwards.

- (B) The prime broker and 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; or
  - (2) With respect to the second type of prime brokerage arrangement:
    - (i) One SD (the “executing dealer”) enters into a Covered Transaction with the counterparty (the “original Covered Transaction”);
    - (ii) Upon satisfaction of certain conditions, the second SD (the “prime broker”) is required to accept novation of the original Covered Transaction; and
    - (iii) As a result of the foregoing:
      - (A) The executing dealer and the counterparty are no longer parties to the original Covered Transaction;
      - (B) 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 charged by the prime broker) to the terms and conditions of the original Covered Transaction; and
      - (C) The prime broker and 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 two SDs and no apportionable business conduct obligation is left unallocated between such SDs.
- (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 each SD 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 each SD that:
  - (1) 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;
  - (2) It will not be responsible for the compliance of the other SD with the apportionable business conduct obligations allocated solely to such other SD; and
  - (3) 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 each SD will remain responsible for fulfilling all applicable apportionable business conduct obligations allocated to it until such expiration or termination.



- (e) Each SD makes and retains a record of the applicable 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 (Records; retention and inspection), and makes such records available to the Commission upon request.

Further, with respect to the market for Exempt FX Transactions where the Division understands there is significant participation by executing dealers that are not required to be registered as SDs, the Division believes that no-action relief is warranted with respect to the External Business Conduct Standards as they relate to Exempt FX Transactions executed under prime brokerage arrangements where the prime broker is an SD, but the executing dealer is not an SD. However, the Division believes that such relief should be limited to relief, for the SD acting as prime broker, from the obligations under Commission regulations §§ 23.431(a)(3)(i) and 23.431(b), which require the disclosure of the mid-market mark of the Exempt FX Transaction, and that the SD provide its counterparty with a scenario analysis if requested. The Division believes that these are the only obligations of an SD acting as prime broker in a prime brokerage arrangement with an executing dealer that is not an SD that would be impossible or impracticable for such SD to perform. The Division is not persuaded that such SD should be given relief from the remainder of the External Business Conduct Standards at this time. 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 Commission regulations §§ 23.431(a)(3)(i) or 23.431(b) with respect to an Exempt FX Transaction with a counterparty executed under a prime brokerage arrangement, subject to the following conditions:

- (a) The SD (as prime broker) has entered into a prime brokerage arrangement that meets the description above but for the fact that the executing dealer is not a SD; and
- (b) Prior to entering into the Exempt FX Transaction, the SD notifies the counterparty that it will not perform its obligations under Commission regulations §§ 23.431(a)(3)(i) (disclosure of the price and mid-market mark) or § 23.431(b) (scenario analysis) with respect to Exempt FX Transactions entered under the applicable arrangement in reliance on this letter.

The Division recognizes that the conditions of the no-action relief described above may require SDs 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 May 15, 2013, provided that such Covered Transactions are conducted under 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 a 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 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. For example, and without limitation, 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; Adam Kezsbom, Special Counsel, at (202) 418-5372, or Jason Shafer, Attorney-Advisor, at (202) 418-5097.

Very truly yours,

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