

FS Regulatory Brief

CFTC Provides EBC Relief – Saves Prime Brokerage Arrangements

May 2013

The Commodity Futures Trading Commission (“CFTC”) acted on April 30, 2013 to provide firms that trade swaps under prime brokerage arrangements with guidance and relief on how to meet the external business conduct (“EBC”) duties to counterparties. This relief was provided to address a disconnect between EBC assumptions and prime brokerage reality. The EBC standards assume that a single swap dealer participates in a trade and can both vet the counterparty and provide required information about the trade. In prime brokerage arrangements, however, the prime broker knows the counterparty, while the executing dealer knows the trade. Together, they can meet EBC, but separately they cannot.

The relief differs for prime brokerage arrangements between two registered swap dealers (“SDs”) and those that involve a SD prime broker and a non-registered executing dealer. At a high level, the relief:

- For prime brokers and executing dealers that are both SDs:
 - Permits them to allocate (or “apportion”) enumerated EBC duties between themselves to provide the fully required EBC coverage for a counterparty.
 - Requires them to enter into new documentation to memorialize their allocation of duties and to disclose this allocation to the counterparty.
 - Gives relief from the EBC standards until May 15, 2013 to firms in prime brokerage relationships in existence as of April 30, 2013.

- For prime brokers that are SDs, and executing dealers that are not SDs:
 - Removes the prime broker’s obligation to provide the price, pre-trade mid-market mark, or scenario analysis for foreign exchange swaps and forwards.

The CFTC took this step to avoid disrupting the prime brokerage business model which permits counterparties to seek prices from many executing dealers (SDs, as well as market participants who are not required to register as SDs) while facing just one prime broker. SDs must otherwise comply with their EBC duties starting May 1, 2013. The relief remains in effect until replaced by a final rule or order.¹

This **FS Reg Brief** describes the relief provided for EBC compliance by firms in prime brokerage arrangements and highlights the practical steps necessary to put this relief into action.

¹ In related EBC relief, on May 1, 2013, the CFTC issued a second no-action letter that extended previously granted relief for certain foreign currency transactions. In December 2012, the Commission had provided relief from a SD’s obligation to provide the pre-trade mid-market mark in connection with physically settled FX swaps and forwards involving currencies among the top 13 deliverables, as described by the Bank for International Settlements (the “BIS 13” currencies). The May 1st letter extended no action relief, under the same terms but more broadly, to the BIS 31 currencies.

The CFTC also provided no-action relief from the requirement that SDs provide a pre-trade, mid-market in Treasury-exempt transactions initiated on anonymous electronic trading platforms, whether or not the platform is a swap execution facility or designated contract market, provided that only eligible contract participants participate on the platform and that real-time tradeable bid and offer prices are readily available to the counterparty.

What are the EBC challenges from prime brokerage arrangements?

Prime brokerage relationships permit a counterparty to establish a customer relationship with a single firm (its “prime broker”) in order to seek prices and execute swaps with multiple firms (“executing dealers”). Either just the prime broker, or both the prime broker *and* the executing dealers, are SDs.

The EBC rules require a SD to vet its counterparty, enter into documentation with that counterparty, and provide the counterparty with trade-specific information before and after trading. In the prime brokerage relationship, the ability to meet the EBC duties is split between the prime broker and executing dealer. The prime broker establishes the customer relationship and enters customer relationship documentation. The executing dealer supplies trade information and disclosures; it may or may not have a pre-existing relationship and documentation with the prime broker’s counterparty outside of the prime brokerage arrangement. Where an investment advisor is trading for multiple accounts under its management, the executing dealer may not even know the identity of the principal(s) to a trade prior to entering the prime brokerage trade.

Which prime brokerage arrangements qualify for relief?

All prime brokerage arrangements covered by this relief begin with a counterparty (that is not a swap dealer) opening an account with the prime broker (that is a SD). The prime broker conducts know-your-counterparty reviews through an on-boarding process. The counterparty (or an investment advisor acting on behalf of the counterparty) seeks prices and enters swaps by interfacing with the executing

dealer via the prime broker arrangement. The CFTC identified two types of these prime brokerage arrangements that qualify for relief.

Limited agency arrangement

In this arrangement, the prime broker gives the counterparty limited agency powers that permit the counterparty to negotiate a swap directly with an executing dealer. The executing dealer commits to the material terms and conditions of a swap with the counterparty. Then the prime broker enters into a swap with the counterparty that has “substantially identical” terms and conditions to those agreed to with the executing dealer. The prime broker also enters a second swap with the executing dealer on substantially equal but opposite terms and conditions.

Novation arrangement

In this arrangement, the counterparty enters into a swap with the executing dealer in accordance with pre-agreed parameters set with the prime broker. The original transaction is given to the prime broker, which must accept novation of the original swap with the counterparty. As a result, the executing dealer and the counterparty are no longer parties to the original trade. The prime broker and the executing dealer then enter into a second swap on substantially equal but opposite terms and conditions.

Relief for prime brokerage arrangements between two SDs

The relief permits allocation of the transaction-specific EBC duties between the two SDs that are prime broker and executing dealer, respectively. They may decide how best to allocate (or “apportion”) the EBC duties in the following chart to a single counterparty, as long as all of the duties are fulfilled.

Apportionable external business conduct requirements

Rule	Rule Number
Know Your Counterparty	23.402(b)
True Name and Owner	23.402(c)
Reliance on Representations, Manner of Disclosure, Format of disclosure	213.402(d)-(f)
Verification of Counterparty Eligibility	23.430
Disclosures of Material Information	23.431
Clearing Disclosures for Swaps Not Required to be Cleared	23.432(b)
Recommendations to Counterparties (Institutional Suitability)	23.434
Requirements for Swap Dealers Acting as Advisors to Special Entities	23.440
Requirements for Swap Dealers and Major Swap Participants Acting as Counterparties to Special Entities	23.450
Political Contributions by Certain Swap Dealers	23.451

To rely on this relief, the following conditions must be met:

- The prime brokerage relationship between two SDs is pursuant to a written agreement that provides for either the limited agency or novation arrangement described earlier.
- The two SDs allocate all of the EBC duties delineated above between them through a written agreement that also provides for notice of the allocation of duties to the counterparty.
- Records must be retained regarding the above under CFTC recordkeeping rules.

Relief for prime brokerage arrangements with one SD trading FX swaps and forwards

The CFTC also offered narrower relief for prime brokerage arrangements where the executing dealer is not a SD, and the counterparty is trading foreign exchange swaps and forwards (these products are exempt from most CFTC rules due to last

year's determination by the US Department of Treasury).² The prime broker SD is relieved from having to provide the price, pre-trade mid-market mark, or a scenario analysis (if requested) for exempt FX swaps and forwards. To rely on this relief, the following conditions must be met:

- The prime brokerage relationship is between a SD and a non-registered executing dealer and is pursuant to a written agreement that provides for either the limited agency or novation arrangement described above.
- Prior to entering into an exempt FX swap or forward, the prime broker notifies the counterparty that it will not provide the price, mid-market mark, or scenario analysis.

² In this situation, the executing dealer has no actual or inferred EBC duties under CFTC rules. The prime broker SD, however, has full EBC duties including for FX swaps and forwards because under Dodd-Frank the Treasury determination does not extend to EBC duties.

Limits of this relief

The CFTC noted that this allocation of EBC relief does not apply to more general protections afforded customers. Specifically, registered swap dealers remain subject to those requirements that fall outside of those delineated in the above chart (e.g., anti-fraud, and confidentiality).

Next steps

The relief gives affected participants a very short amount of time – two weeks – to review their existing prime brokerage arrangements, determine whether this relief is available and desirable, and document the arrangements in accordance with the relief.

- Prime brokers and executing brokers must ensure that their arrangements are contained in written agreements that include all the conditions in the no action letter.
- Prior notice must be provided to counterparties (or their duly authorized representative) of how the prime broker or executing dealer are complying with the EBC duties or, in the case of exempt foreign exchange swaps and forwards, not providing pre-trade information.
- After May 15th, if conditions are not met, the prime broker will have to evaluate whether/how to continue to deal with high risk accounts where the prime broker cannot perform pre-trade EBC requirements.

Some dealers will be in a better position than others to complete their documentation within the narrow time frame. As the prime brokerage relationship is a common trading arrangement, dealers in several asset classes were proactive about anticipating that a quick turnaround would be necessary and drafted a

document that allocates the EBC responsibilities between the executing dealers and prime brokers. Upon execution by both parties (possibly through a protocol process), the document will formally allocate the trade-related EBC requirements to the executing dealer, such as the delivery to the prime broker's counterparty of the pre-trade mid-market mark, primary economic terms, and scenario analysis (upon request). The prime broker will be responsible for the remainder of the responsibilities, including vetting the counterparty to verify it is eligible to trade swap products and providing all necessary disclosures, including the material risk disclosures for the products to be traded.

While we may see a relatively quick turnaround in regards to execution of the annex between most dealers, some dealers may not agree to the specific allocations and attempt to negotiate their own terms. In the interim, some executing dealers have elected to provide the pre-trade disclosures to the prime broker's counterparty in order to ensure a smooth transition under the new regulatory requirements.

It is worth noting, too, that the terms of the no action represent a step back from the CFTC's prior stated position, by limiting an SD's responsibility for EBC compliance solely to the EBC responsibilities allocated to it. In other words, prime brokers will not be jointly and severally liable for EBC failures of its executing dealer and vice versa. In addition, in crafting the relief the CFTC deferred to industry arrangements in allocating responsibilities rather than prescriptively assigning duties. These are significant aspects of the relief that will make it more workable.

Finally, the CFTC no action letter indicates that further, more permanent EBC relief for prime brokerage arrangements may be coming in the form of a final rule or final order.

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