Documenting and Negotiating Prime Brokerage Agreements

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Presentation
SIA Form 151 Agreement for Prime Brokerage Clearance Services — Fund’s clearing broker facilitates the clearance of securities transactions with the fund’s prime broker.
Summary of Prime Broker Services

- **Custodial-type services:** The prime broker holds/credits fund assets in different client accounts. Each account serves a different purpose
  - **Brokerage account:** The brokerage account is used simply to hold fully paid fund assets. Generally, these assets remain in the control of the fund, are not used or rehypothecated by the prime broker and are identified as customer property on the books and records of the prime broker
  - **Margin account:** The margin account contains the fund’s securities which are held as collateral to satisfy the fund’s margin financing obligations to the prime broker

- **Trade clearing and settlement:** The prime broker is generally responsible for settling trades on behalf of the fund and responsible for maintaining the paperwork associated with the clearing and executing of a transaction. It acts as a liaison between the fund and a clearing corporation (SIA Form 151). The clearing broker helps to ensure that the trade is settled appropriately and the transaction is successful
### Summary of Prime Broker Services (continued)

- **Routing and technology:** A prime broker will typically give a fund’s traders access to its proprietary electronic order management and trading tools. These are used by the traders to execute the fund’s investment strategy. There are many different proprietary electronic trading systems that are geared toward specific trading strategies. Some of these are offered by the prime broker itself; other times the trading system is provided by a third party. It is important for the prime broker to be able to interface with these trading systems.

- **Reporting:** A prime broker will prepare a trade confirmation for each trade it settles and will send this information to the fund for review. Typically, this information is in electronic format and made available via the web with real time access, or at the very least, at the end of each trading day.

### Notes:

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Summary of Prime Broker Services (continued)

- **True custodial service:** A prime broker may open a custodial account with a bank/trust company affiliate of the prime broker which will act as a third party custodian for the fund. The fund can use this account for the segregation/safekeeping of assets. The fund can also open this account with an independent third party that is not an affiliate of the prime broker.

- **US leverage:** Many fund investment strategies require the use of leverage. Two types of prime broker financing platforms in the US:
  - Regulation T (2 to 1)
  - Portfolio Margining (approximately 6.5 percent to 1)

- **Non-US leverage:** Fund can obtain higher margin financing outside of the US by opening a non-US prime brokerage account.

Notes:
Summary of Prime Broker Services (continued)

- **Covering short sales:** Short selling is when a fund sells shares it does not own with the expectation to purchase those same shares in the future at a lower price. To avoid “naked short selling” SEC created certain requirements under Regulation SHO. Regulation SHO requires each broker-dealer who accepts a short sale trade to perform a “locate” of the shares, meaning:
  - The broker-dealer has borrowed the security; or
  - Entered into an agreement to borrow the security; or
  - Has reasonable grounds to believe that the security can be borrowed so that it can be delivered on the date it is due to be delivered

All locates must be made and documented by the broker-dealer prior to effecting a short sale transaction. As a result, many prime brokers require the fund to identify any short sales as “short” at the time of the trade as well as perform its own locate.

Notes:
Summary of Prime Broker Services (continued)

- **Sweep functions**: An arrangement can be made with the prime broker to sweep all cash balances into a high quality overnight security. This gives the fund the ability to generate income and to protect against prime broker insolvency.

- **Bridging of trading agreement obligations**: Some financial institutions use the prime brokerage agreement as a collateralization agreement for derivative transactions. For example, an ISDA obligation may be collateralized, not under the Credit Support Annex, but under the prime brokerage agreement. This permits the ISDA counterparty to collateralize the obligations under a prime brokerage model which may result in lower margin payments. Due to recent regulatory changes under Dodd-Frank as well as changes in the market, derivative transactions that are cleared may not be eligible to be bridged under the prime brokerage agreement.

Notes:
Dodd-Frank Issues – Prime Brokerage

- Prime brokers are required under Dodd-Frank to establish adequate “know your customer” procedures
- Prime broker must disclose any “conflicts of interest”
- Executing broker and not prime broker has the duty to report trade activity to swap data repositories
- It may be impracticable for prime brokers and executing dealers to comply with the External Business Conduct Rules, which require certain information (including pre-trade mid-market quotes and risk disclosures) to be provided to clients
- Possible ISDA protocol between prime broker and executing broker may sort out disclosure requirements and pre-traded mid market disclosure requirements

Notes:
How Many Prime Brokers Should a Fund Use?

- It is advisable for hedge funds to employ the services of more than one prime broker and to spread its assets among several different financial institutions. Doing so achieves several important results:
  - Reducing potential credit risk
  - Differences in prime broker products offered
  - Establishing trading relationships with several financial institutions
SEC No Action Letter

- In 1994 the SEC established minimum net equity requirements for prime broker accounts. Currently, the SEC minimum is $500,000 in cash or securities. In the event the fund’s minimum net equity falls below $500,000, the SEC gives the fund five business days to restore the minimum net equity.
- Many prime brokers require net equity minimums in excess of the SEC minimum, particularly if they are “portfolio margining” customers.

Notes:
Bankruptcy Issues (US Broker-Dealer)

- As we saw with the bankruptcy of Lehman’s US broker-dealer, cash and securities held in the prime brokerage account are considered customer property. This is the case even where the prime broker has rehypothecated a security.
- Fully paid fund assets may be moved from the prime brokerage account to a third-party custody account to hedge against prime broker insolvency risk.
- Cash held in the prime brokerage account can be swept into an overnight security.

Notes:
Give-Up Arrangements

- Some prime brokers will permit a client to enter into a give-up arrangement
- This permits the client to enter into transactions (typically FX) in the name of the prime broker which are then given up to the prime broker (two back to back transactions)
- Allows the client to economically benefit from trading in the name of the prime broker

Notes:
Margin Lockup Agreements

- Margin terms are generally determined by the prime broker in its sole discretion and are subject to change without prior notice
- This can create uncertainty for prime brokerage clients
- Margin Term Lockup Agreements establish margin terms for a fixed period of time (30 days to 120 days are most common)
- This lockup period can be subject to certain conditions:
  - May be subject to additional credit-based event triggers (NAV declines, portfolio concentration restrictions and other investment restrictions)
  - May be subject to the prime broker’s own funding increases and credit downgrades
  - May incorporate cross-defaults between the client, the prime broker and affiliates of the prime broker

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Negotiation of the Prime Broker Agreement

- The prime broker agreement is a completely proprietary document. There is no industry standard prime broker agreement form and as a result, the negotiation process will differ from institution to institution.
- There are commonalities between prime broker agreements and pitfalls which should be avoided. The upcoming collection of negotiation points is by no means exhaustive, but is meant to serve as a basis, when reviewing a prime broker agreement, to identify provisions which require negotiation and upon what issues to focus.

Notes:
Commonly Negotiated Terms

(In Alphabetical Order)

- **Applicable law:** The laws of the State of New York should apply (without regard to its choice of law provisions, except Sections 5-1401 and 5-1402 of the General Obligation Laws of the State of New York)

- **Arbitration:** Many prime brokers wish to require the fund client to automatically submit to arbitration, in the event of a dispute under the prime broker agreement. It may be advisable to insist on resolving any disputes through litigation, with an option, at the sole discretion of the fund client, to use arbitration as an alternative dispute resolution forum

- **Collateral:** Typically under a prime brokerage agreement, the assets a client places in custody with their prime broker automatically gives the prime broker a security interest and lien on these assets. Hence, they become collateral for the purposes of any and all transactions the client has with the prime broker and any of the prime broker’s affiliates. This includes transactions under an ISDA Master Agreement or a Repurchase Agreement. The prime broker is granted rights of rehypothecation with regard to these assets in accordance with Rule 15c3-3 of the Securities Exchange Act of 1934

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Commonly Negotiated Terms (continued)

- **Conflict of terms:** Some prime brokers want the terms of the prime broker agreement to be incorporated into, and otherwise trump, any conflicting terms contained in any other agreement between the fund, the prime broker and of the prime broker’s affiliates. This may serve to amend favorable terms existing in trading agreements between the parties (such as an ISDA Master Agreement or Repurchase Agreement). This concept should be deleted in its entirety from the prime broker agreement or limited in scope to security interest and default rights.

- **Delivery of NAV financial statements:** Some prime brokers may require the fund to send unaudited monthly, unaudited quarterly or annual audited financial statements. For consistency, these terms should be identical to what is contained in an ISDA Master Agreement (or other trading agreement). Sample terms: NAV report delivered within 20 days after the end of the relevant calendar month and 120 days after the end of the relevant fiscal year.

Notes:
Commonly Negotiated Terms (continued)

- **Delivery of margin**: The prime broker may, from time to time, make payment demands from the fund. Usually, the prime broker wants the fund to transfer collateral immediately after a demand is made. We recommend inserting a specific cut-off time for same day transfers of collateral. For example, 10:00 a.m. as a cut-off means that a collateral call made by the prime broker at or before 10:00 a.m. would be satisfied by the fund by the close of business on the same day, while a collateral call made after 10:00 a.m. would be due to the prime broker by the close of the next business day.
Commonly Negotiated Terms (continued)

- Default/cross default:
  - These particular provisions require close examination and scrutiny. The goal is to define narrowly and with as much specificity as possible all events of default under the prime broker agreement.
  - Some agreements contain what is known as a “Material Adverse Change” clause (otherwise known as a “MAC” clause) or an “Adequate Assurance” clause. These clauses serve to give the prime broker the ability, at any time and for any reason, to designate an event of default under the prime broker agreement (and all other agreements with their affiliates). These clauses should be removed from the agreement. In its place, it is preferred to insert events of default which are tied to the occurrence of specific discernible events. For example, these could include (a) Net Asset Value decline terms, (b) a keyperson departure term, (c) a change of investment manager term or (d) a default of material representation under the prime broker agreement. When addressing these points with the prime broker, keep in mind terms you would want to see in an ISDA Master Agreement, so that these terms can be replicated.
  - Many prime brokers use very broadly worded cross default provisions. Under these provisions, a single default on any agreement (including derivative trading agreements and repurchase agreements) between the fund and the prime broker, of its affiliates, or any third party, no matter how minor, will constitute a default under the prime broker agreement. To minimize this potential risk, it is recommend (a) to use a cross-acceleration model; (b) to implement an administrative error exception or (c) to use a cross-default threshold which would be consistent with an ISDA Master Agreement.

Notes:
Commonly Negotiated Terms (continued)

- **Dispute resolution**: A fund may want to insert a dispute resolution provision into the prime brokerage agreement, particularly where an ISDA obligation is bridged as a prime brokerage obligation which would require the prime broker to seek resolution from an independent third party financial institution.

- **Fees and costs**: Most prime brokers charge fees relating to their settlement, clearing and trade execution services. These amounts are normally deducted from the account directly. It is important to receive all fee schedules from the prime broker so that you can anticipate what fees will be charged on a monthly basis. In the event a prime broker wishes to change its fee schedule, you should receive written notice of these fee changes prior to their effective date, and receive a revised written fee schedule reflecting the new fees.

Notes:
**Indemnification:** Most prime broker agreements contain a sweeping indemnity clause, which would require the fund to indemnify the prime broker for all costs and damages (for example, direct, indirect, consequential, special damages) it sustains as the result of dealing with the fund or with an investment manager on the fund’s behalf. While most prime brokers will not remove these provisions entirely, many prime brokers will scale them back somewhat. In these cases, indemnities should be limited to direct damages, reasonable expenses and out-of-pocket costs incurred or sustained by the prime broker. Legal fees should not be considered out-of-pocket costs unless they are incurred by external counsel.

**Liability of prime broker:** Many prime broker agreements contain language that shields the prime broker from any liability to the fund under the prime broker agreement. We generally see our fund clients requesting the following standard of care in their prime broker agreements: negligence (sometimes gross negligence), bad faith, willful misconduct, breach of the agreement, illegality or fraudulent acts.
Commonly Negotiated Terms (continued)

• **Liability of fund**: As in all trading agreements, it is advised to insert into all prime broker agreements, a standard limitation of liability provision, which limits the prime broker’s ability to seek recovery solely from the assets of the fund and not affiliates of the fund or the investment manager.

• **Minimum net equity**: The minimum amount should be identified in the body of the prime brokerage agreement. This ranges from 500,000 to 5,000,000 depending on the requirements of the prime broker.

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Commonly Negotiated Terms (continued)

- **Movement of fund assets:**
  - **Request by the fund:** Some prime broker agreements contain provisions stating that the prime broker has the right to hold all assets until the satisfaction of all obligations to the prime broker and its affiliates across all agreements. Funds generally like the ability to move assets out of the prime brokerage account immediately, which is particularly important where there is a credit concern related to the prime broker. Therefore, the prime brokerage agreement should not restrict the fund’s ability to move assets out of the prime brokerage account, subject to the fund satisfying all then due and unpaid obligations under the prime brokerage agreement. It is also advised to insert a provision into the body of the agreement giving an unrestricted right of the fund to remove cash and fully paid securities from the prime brokerage account.
  - **Movement of fund assets between affiliates of the prime broker (including by entitlement order):** Generally, all fund assets should remain in the prime brokerage account, subject to a few narrow exceptions: (i) where there is a due and unpaid obligation by the fund to an affiliate or (ii) when the fund is in default. It is advised to add language into the prime brokerage account which limits the prime broker’s ability to move assets to affiliates subject to the events in (i) and (ii) above.

Notes:
Commonly Negotiated Terms (continued)

- **Party acting as prime broker:** In many cases, the prime broker agreement will identify the prime broker and all its affiliates as parties to the prime broker agreement. For US prime broker agreements, this should be permitted only for the purpose of granting the affiliates a security interest in the fund’s assets and cross-affiliate set-off rights where the fund is in default. Ideally, the prime broker should be identified only as the party providing prime broker services to the fund under the prime broker agreement.
Commonly Negotiated Terms (continued)

- Rehypothecation:
  - **140 percent limitation:** All prime broker agreements permit the prime broker to rehypothecate the fund’s assets held in a client’s margin account. Rehypothecation is commonly defined as the right to sell, lend, use or vote a security. All prime brokers that are US registered broker-dealers are limited in the amount they can rehypothecate as set forth in Rule 15c3-3 of the Securities Exchange Act of 1934, as amended (the “34 Act”). The 34 Act permits the prime broker to rehypothecate a fund’s assets in an amount up to 140 percent of the fund’s total debit balances to the prime broker. It is important to note that prime brokers that are not US SEC registered broker-dealers are not subject to this 140 percent limitation. When negotiating a prime broker agreement with a prime broker that is not a US SEC registered broker-dealer, some of our fund clients may request a contractual rehypothecation limit similar to that imposed under the 34 Act. This will ensure the prime broker does not “over rehypothecate” a fund’s assets.
  - **Exclude cash:** Cash is not subject to rehypothecation and should be excluded in the rehypothecation provision.

Notes:
Commonly Negotiated Terms (continued)

- **Voting:** Another important concept connected with rehypothecation is whether a fund will be able to vote securities it owns and custodies at a prime broker. Generally, once a fund’s asset is rehypothecated by the prime broker, it may not be returned to the prime broker account in time for a fund to exercise its voting rights. If this is a concern to a fund, then it may consider addressing this with the prime broker while the prime broker agreement is being negotiated, so that separate custody arrangements can be made with the prime broker in advance in order to preserve the fund’s voting rights. Some funds request that their assets be segregated upon demand by the fund or at least require that the prime broker make “best efforts” or “reasonable efforts” to segregate such assets upon demand.

- **Tax:** It is important to note that there may be adverse tax implications when a dividend payment from a rehypothecated security is received from the prime broker. To avoid this, either the prime broker should return the security to the prime brokerage account on each dividend record date or make an “in lieu” dividend payment which would put the fund in the same tax position as if the fund had received the actual dividend payment.

Notes:
Commonly Negotiated Terms (continued)

- **Return of assets**: The fund should insert into each prime brokerage agreement the right to withdraw assets from the prime brokerage account. The prime broker should comply with the fund request; provided that the fund has not triggered a default under the agreement and the fund has met all of its then-due and unpaid obligations to the prime broker and its affiliates.
Commonly Negotiated Terms (continued)

- **Review of statements:**
  - **Activity statements:** There are two basic types of written reports a prime broker will send. One is a written trade activity report (a trade confirmation), which is in relation to specific trades. The other is a general account statement, which addresses all account activity within a certain period (generally monthly). In relation to these reports, it ordinarily attempts to implement a fixed review and dispute expiration period — meaning, you have a short length of time upon which to review these reports and raise any disputes. In most cases, the review period is short (ranging between 2 and 5 business days in the case of a trade report, and five to ten business days, in the case of a monthly account statement). Also, it is important to consider the particulars surrounding the form in which the dispute must take. Try to avoid requirements that your dispute take written form — a verbal dispute should be sufficient.
  - **Asset statements:** Funds generally like to monitor what assets are being held in their prime broker accounts. Funds monitor on a daily basis, either via web access or by receiving written statements from the prime broker, what fund assets are held, in which account fund assets are held, with whom fund assets are held, in what jurisdiction fund assets are held and whether or not fund assets are rehypothecated. Fund assets held in the cash account should be capable of removal by the fund at will, while assets held in the margin account are likely to be rehypothecated by the prime broker and cannot be removed by the fund without adequate prior notice to the prime broker and some sort of substitution of assets.

Notes:
Commonly Negotiated Terms (continued)

- **Set-off:** Some prime brokerage agreements give the prime broker the right to exercise set-off rights in its sole discretion at any time. The right of set-off should be limited as a remedy only after the fund has defaulted to the prime broker.

- **Sole discretion standards:** Often, throughout a prime broker agreement, the prime broker will want to make various determinations and otherwise act in its sole discretion. This is not advisable, especially as it would relate to the determination of whether a default has occurred under the prime broker agreement. Instead, it is recommended that the prime broker act in good faith and in a commercially reasonable manner at all times under the prime broker agreement. Generally, under most circumstances, a prime broker will want to exercise its sole discretion when determining whether or not it will settle a particular transaction on behalf of a fund, extend margin to a fund and what types of assets it will accept as collateral from a fund.

Notes:
Commonly Negotiated Terms (continued)

- **Sub-custodians**: Generally, all fund assets should be held, at all times, with the prime broker and not with affiliates of the prime broker. In the event the fund engages in trading activity in jurisdictions with certain legal and/or regulatory restrictions, many prime brokers will use the custody services of foreign entities or affiliates. Once selected, the prime broker should have some duty to monitor the activity of all sub-custodians and agents and determine their suitability on an ongoing basis.

- **Termination and amendments**: Generally, either the fund or the prime broker can terminate a prime broker agreement at any time. New prime broker relationships can take months to establish; in this regard, it is advisable to insist on at least 30 days’ prior written notice from the prime broker, before the prime broker can terminate the prime broker agreement. As a related issue, most prime brokers retain the right to amend the prime broker agreement at any time. Similarly, it is important to insist on at least 30 days’ prior written notice before any amendment by the prime broker can be effectuated.

Notes:
Commonly Negotiated Terms (continued)

- **Transfer of prime broker obligations:** It is suggested to try to limit the ability of the prime broker to transfer its obligations without the fund’s prior written consent because it is impossible to know the credit quality of any successor prime broker. Regarding the transfer of a prime broker’s obligations to its affiliates, some of our fund clients request to limit these transfers to affiliates that are governed under the same regulatory regime and that have the same tax and legal jurisdiction as the prime broker.

- **Issues where prime brokerage services are given from the United Kingdom:**
  - Under the UK Financial Services Authority rules (the “FSA Rules”), all UK prime brokers have to classify the status of their clients. Professional client status is appropriate for investment funds (not eligible counterparty status). Professional clients will receive slightly more protections from the prime broker under the FSA Rules than would an eligible counterparty.
  - Under FSA Rules, the UK prime broker can rehypothecate all of the fund’s assets held in the prime brokerage account.
  - Prime brokerage customers may become general creditors to the prime broker with respect to all cash and securities in the account.
  - Leverage financing amounts can exceed the US limits (Reg T and Portfolio Margining).

Notes:
About Schulte Roth & Zabel
SRZ’s Investment Management Practice

As the premier destination firm for the investment management industry, SRZ advises nearly half of the 100 largest hedge funds and more than 3,000 investment funds. The firm’s 75+ attorney Investment Management Group represents many well-known funds, investment advisers, commodities trading advisers, brokerage firms and banks in connection with their investment products and services. The group assists the firm’s clients with all aspects of running an investment management business, including the initial structuring of the business, “seeding” arrangements (in which an institutional investor invests with a management firm in return for a share of the firm’s business), ongoing operational, regulatory and compliance issues, and acquisitions and dispositions of investment advisers and broker-dealers.

The firm’s involvement with a client does not end with the structuring and launching of a new business or fund. For many of the hundreds of investment partnerships, offshore funds and mutual funds the firm represents, and for many of its investment adviser and broker-dealer clients, the firm’s attorneys serve in a general counsel capacity, supplying ongoing advice relating to regulatory and compliance matters, trading practices, employment issues, the use of soft dollars and structuring derivatives transactions, as well as tax, bankruptcy and ERISA issues. In addition to day-to-day compliance advice, the group’s regulatory & compliance attorneys — many of whom have served at the SEC, the CFTC and the U.S. Attorney’s Office, as well as “in-house” — conduct on-site legal compliance reviews, provide assistance in drafting compliance manuals, help draft and submit Form ADV registration statements, and counsel clients as they prepare for and undergo compliance examinations by federal regulators.

SRZ’s Structured Products & Derivatives Practice

SRZ has been active in the structured products and derivatives market for over 25 years, and our Structured Products & Derivatives Group is widely recognized as one of the most sophisticated and talented in the legal profession. We structure, draft and negotiate a variety of complex structured investment vehicles, securitized products, collateralized debt obligations and credit default swaps on behalf of investment managers, sellers and servicers of assets, issuers, underwriters, placement agents, trustees, purchasers, remarketing agents, investors, credit enhancers and liquidity providers. We have particular expertise in advising asset managers on the buy-side perspective and the related myriad business and operational issues involved with trading on swap execution facilities. Our attorneys have acted as deal counsel, manager’s counsel and underwriter’s counsel in many asset-backed securities transactions, highly structured collateralized debt obligations and credit default swaps. Since 2007, we have also assisted numerous clients in restructuring SIVs.

SRZ understands how market pressure points and regulatory challenges (such as the rules mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act), often appearing without warning (such as the contagion of market disruptions caused by the U.S. subprime loan crisis), can affect our clients’ businesses. We have unparalleled experience in structuring solutions in the face of such conditions. In doing so, we utilize our firm’s multi-disciplinary expertise, drawing on the experience of attorneys in such relevant areas as investment management, securities, bank regulatory, broker-dealer, tax, insolvency and ERISA. While our attorneys’ collective experience is diverse, our focus is singular: to effectively and efficiently help our clients achieve their financing and risk-transfer needs, especially in times of market and regulatory turbulence.
SRZ's Trading Agreements Practice

SRZ is well-versed in all types of derivatives agreements and has a team of more than 15 attorneys solely dedicated to representing funds in this specialized practice area. Our lawyers regularly advise and provide expert service in all aspects of trading agreements, ranging from those published by industry trade groups such as the International Swaps and Derivatives Association (ISDA), the Securities Industry and Financial Markets Association (SIFMA) and the International Securities Lending Association (ISLA) to agreements that are entirely proprietary in nature and specific to a particular financial institution. We also provide regulatory and compliance advice related to trading agreements, proactively advising clients on issues related to the Dodd-Frank Wall Street Reform and Consumer Protection Act and the SEC's, CFTC's and EC's emerging trading, reporting and recordkeeping rules along with ISDA's new documentation for the types of transactions that will be subject to these new regulations.

Our expansive industry knowledge extends to the widest range of derivative product agreements and account agreements (e.g., ISDA Master Agreements, Prime Brokerage Agreements, Margin Term Lockup Agreements, Custody Agreements, Collateral Control Agreements, Repurchase Agreements, Securities Lending Agreements, Master Confirmations and Long Form and Short Form Trade Confirmations, Futures and Options Agreements, Master Give-Up Agreements, Executing Broker Agreements, Clearing Broker Agreements, Confidentiality Agreements, Master Netting Agreements, Foreign Exchange Trading Agreements, Commodity Agreements). As trading agreements increasingly become tools for clients to achieve their business goals rather than obstacles or sources of financial harm, SRZ vigorously negotiates even industry-standard agreements and helps clients successfully re-examine prime broker and counterparty relationships to reduce counterparty credit risk.
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