ALERTS

CFTC Grants Temporary Relief for FX and Swaps Prime Brokerage Arrangements: Context for Private Fund Managers and Other Investment Advisers

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On April 30, 2013, the Commodity Futures Trading Commission staff issued a letter granting temporary relief to swap dealers from compliance with certain "external business conduct standards" related to foreign exchange and swap prime brokerage arrangements. This relief is not expected to impose any new obligations on investment advisers. However, it forestalls a potential market disruption by providing swap dealers the ability to resolve certain issues in applying the external business conduct standards to current foreign exchange and swap prime brokerage arrangements. Private fund managers and other investment advisers that engage in such prime brokerage arrangements should expect notices from their prime brokers indicating their compliance with this CFTC staff letter.

The Commodity Exchange Act (as amended by the Dodd-Frank Act) requires the CFTC to impose certain business conduct standards on swap dealers in their dealings with counterparties. These external business conduct standards place direct obligations on swap dealers, but also have an indirect effect on private fund managers and other investment advisers.[1]

The central issue necessitating the relief arises in two commonly utilized foreign exchange and swap prime brokerage arrangements. In the first arrangement addressed by the CFTC staff letter, funds (or managers on

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their behalf) enter into swaps or certain foreign exchange transactions with an executing dealer and those transactions are subsequently "given-up" by the executing dealer to the prime broker. The second arrangement addressed by the letter involves funds entering into transactions on the prime broker's behalf, as agent for the prime broker. In each case, the final private fund transaction is between the fund and the prime broker, and there is an equal but opposite transaction between the prime broker and the executing dealer.

Where the prime broker and the executing broker are both swap dealers, each is subject to and required to *fully satisfy* the external business conduct standards; however, because the prime broker and the executing dealer each possesses only the information relating to its portion of the overall transaction, neither party can easily satisfy such standards. Similar issues affect a prime broker dealing with an executing broker that is not a swap dealer, because the prime broker is obligated to fully satisfy the external business conduct standards but it may not have complete information relating to the executing broker's portion of the overall transaction.[2] Left unaddressed, the intermediated market would have been adversely affected, which could have led to serious market disruptions.

This temporary relief permits prime brokers and executing dealers that are swap dealers to allocate between themselves the responsibility to comply with the external business conduct standards. The CFTC staff letter requires that swap dealers (in their role as prime broker and executing dealer) enter into an agreement allocating such responsibilities by May 15, 2013. Today, the International Swaps and Derivatives Association published a protocol for swap dealers to facilitate and expedite the implementation on an industry-wide basis. In a situation where an executing dealer is not a registered swap dealer (which relief is limited to non-swap foreign exchange transactions), the CFTC staff's action relieves the prime broker from certain external business conduct standards. The temporary relief ends on the later of the effective date or the compliance date of any final rule or final order providing similar relief to swap dealers from compliance with the external business conduct standards.

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[1] As a result of the external business conduct standards, an investment adviser is effectively required by its swap dealer counterparties to provide a number of representations and warranties contained in the ISDA August 2012 Dodd-Frank Protocol (among other things, these relate to suitability, independence and sophistication) and will receive certain disclosures with respect to their swap transactions. A copy of the Dodd-Frank Protocol can be accessed at http://www2.isda.org/functional-areas/protocol-management/protocol/8.

[2] For example, if a manager were to trade an aggregated or bunched order and allocate it among its managed funds after the trade is given-up to the prime broker, the executing broker would not be able to comply with the "know-your-counterparty" external business standard under CFTC rule 23.402. Conversely, in such a scenario, the executing dealer will have access to trade information and risks related to the transaction at the time that the funds (or manager on its behalf) enter into the trade and will therefore be in a better position to comply with the pre-trade, mid-market-quote and risk-disclosure obligations under CFTC rule 23.431.

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