

MEMORANDUM

TO: File
FROM: Lourdes Gonzalez
RE: Meeting with Representatives of the Securities Industry and Financial
Markets Association
DATE: November 20, 2015

On November 13, 2015, representatives of the Securities and Exchange Commission (“SEC”) met with representatives of the Securities Industry and Financial Markets Association (“SIFMA”). The SEC representatives were Gary Goldsholle, Heather Seidel, Brian Bussey, Tom McGowan, Randall Roy, John Roeser, Lourdes Gonzalez, Joanne Rutkowski, Andrew Bernstein, Carol McGee, Stacy Puente, Cindy Oh, Michelle Danis, Lourdes Toro, and Kathleen Gross. The SIFMA representatives were Kyle Brandon (SIFMA), Colin Lloyd (Cleary Gottlieb Steen & Hamilton LLP), and Jeffrey Shaffer (Cleary Gottlieb Steen & Hamilton LLP).

During the meeting, the SEC and SIFMA representatives discussed issues related to the Commission’s external business conduct proposal, Regulation SBSR, and their application to security-based swap prime brokerage transactions.



Invested in America

SECURITY-BASED SWAP PRIME BROKERAGE

11/13/2015

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Overview of Security-Based Swap Prime Brokerage

- Security-based swap (“SBS”) prime brokerage arrangements allow a customer (“Customer”) to access liquidity for uncleared SBS from multiple SBS dealers (each, an “Executing Dealer”) while centralizing its bilateral credit relationship with a single SBS dealer (the “Prime Broker”), which acts as credit intermediary*
- The Prime Broker provides credit intermediation by acting as principal counterparty to an Executing Dealer and as principal counterparty to the Customer in mirror image back-to-back SBS, one with the Executing Dealer (the “PB/ED SBS”) and another with the Customer (the “Customer Mirror SBS”). The Prime Broker receives a fee for its credit intermediation
- This arrangement differs from cash securities prime brokerage arrangements because of the executory nature of uncleared SBS transactions**

* These slides address “plain vanilla” prime brokerage structures involving a single Customer and a single Prime Broker. Details regarding more complex structures (e.g., involving an asset manager trading on behalf of multiple clients) can be provided upon request

**Outside the U.S., a Customer may sometimes have integrated cash and SBS prime brokerage arrangements with a single Prime Broker

Benefits of SBS Prime Brokerage

- Establishing an SBS prime brokerage arrangement has many benefits for a Customer:
 - Ability to centralize its credit relationship with the Prime Broker
 - Reduced credit risk and increased collateral efficiencies resulting from increased bilateral netting of the Customer's SBS with the Prime Broker
 - Streamlined trading operations resulting from ability to centralize trade processing with the Prime Broker, which helps to reduce operational risk and expense
 - Access to more competitive pricing from a broader range of Executing Dealers, avoiding the limited access to liquidity that would otherwise result from the Customer's lack of credit relationships with those Executing Dealers

Contractual Relationships

An SBS prime brokerage arrangement is typically documented using the following agreements:

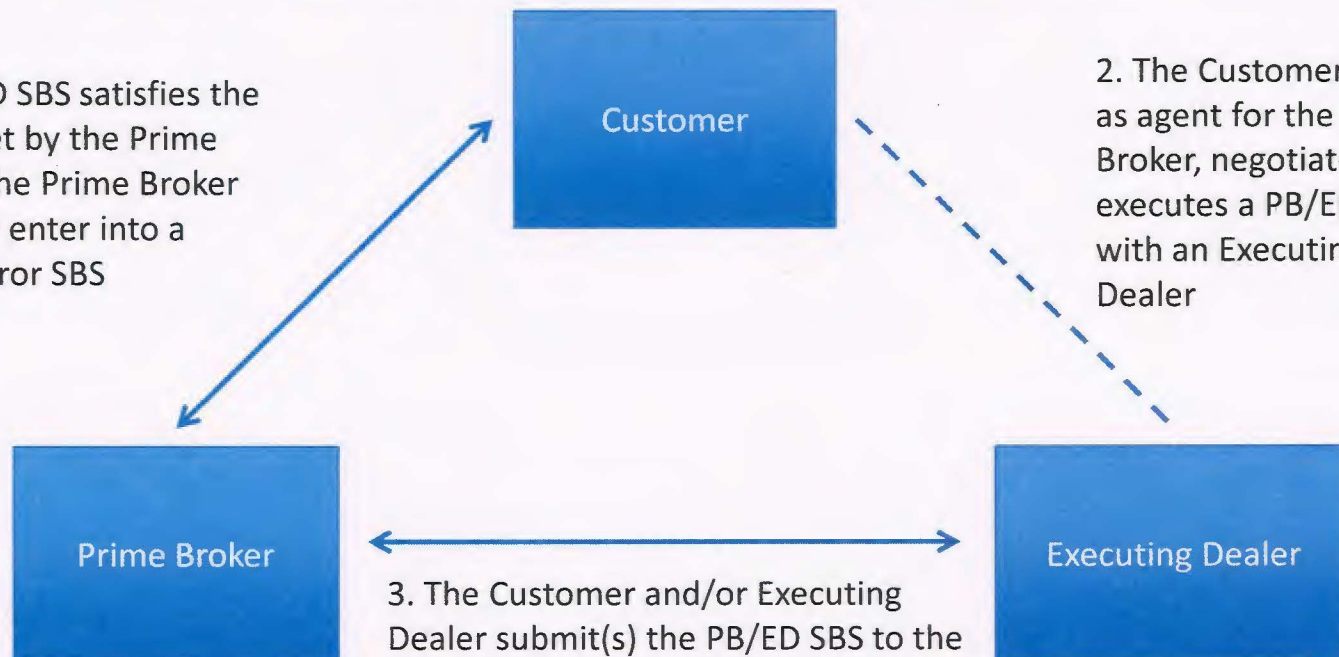
- Prime Brokerage Agreement:
 - Authorizes the Customer, acting as agent on behalf of the Prime Broker, to negotiate and enter into SBS with Executing Dealers approved by the Prime Broker
 - Specifies authorized transaction types and execution parameters
 - Provides for the automatic execution of Customer Mirror SBS upon the Prime Broker's acceptance of authorized PB/ED SBS given up to it by or for the Customer
 - Addresses prime brokerage fees
- Give-up Agreement: provides for an Executing Dealer to transact with the Prime Broker in connection with SBS negotiated by the Customer as agent for the Prime Broker, including the mechanics of the "give up" process, subject to transaction type and execution parameters
- Designation Notice: establishes parameters under which the Prime Broker will accept SBS with a particular Executing Dealer that are negotiated by the Customer as agent for the Prime Broker
- ISDA Master Agreements: the Prime Broker has ISDA Master Agreements (and, as applicable, credit support documents) with the Customer and each Executing Dealer

Diagram of Typical SBS Prime Brokerage Transaction

1. The Customer and the Prime Broker enter into a Prime Brokerage Agreement; the Prime Broker and each Executing Dealer enter into a Give-up Agreement; the Prime Broker sends a Designation Notice to each Executing Dealer

4. If the PB/ED SBS satisfies the parameters set by the Prime Broker, then the Prime Broker and Customer enter into a Customer Mirror SBS

2. The Customer, acting as agent for the Prime Broker, negotiates and executes a PB/ED SBS with an Executing Dealer



Application of External Business Conduct Rules

- Absent relief, the Prime Broker would be responsible for all of the external business conduct obligations applicable to the Customer Mirror SBS:*
 - Rule 15Fh-3(a): Counterparty status as eligible contract participant and special entity
 - Rule 15Fh-3(b): Disclosure
 - Rule 15Fh-3(c): Daily mark
 - Rule 15Fh-3(d): Disclosure regarding clearing rights
 - Rule 15Fh-3(e): Know your counterparty
 - Rule 15Fh-3(h): Fair and balanced communications
 - Rule 15Fh-5: Special requirements for SBS dealers acting as counterparties to special entities
 - Rule 15Fh-6: Political contributions by certain SBS dealers
- The Prime Broker could not, however, provide the Customer with pre-trade disclosures (other than standardized disclosures) for the Customer Mirror SBS until after the economic terms of that SBS had already been established by the execution of the PB/ED SBS

*Rules 15Fh-3(f) (Recommendations of SBS or trading strategies) and 15Fh-4 (Special requirements for SBS dealers acting as advisors to special entities) are unlikely to apply to the Customer Mirror SBS because the Prime Broker is unlikely to make a recommendation to the Customer in connection with an SBS negotiated with an Executing Dealer. However, because the Prime Broker frequently will trade with the Customer in other contexts, it will typically have bilateral documentation with the Customer designed to satisfy those rules

Application of External Business Conduct Rules (Cont'd)

- Absent relief, the Executing Dealer would only be responsible for the following subset of external business conduct obligations with respect to the Customer,* some of which would only apply if it makes a recommendation to the Customer:
 - Rule 15Fh-3(f): Recommendations of SBS or trading strategies
 - Rule 15Fh-3(h): Fair and balanced communications
 - Rule 15Fh-4: Special requirements for SBS dealers acting as advisors to special entities
- However, because the Executing Dealer does not have a bilateral trading relationship with the Customer, it would not have the bilateral documentation with the Customer necessary to ensure that the Executing Dealer satisfies these obligations

*The Executing Dealer would also, with respect to the Prime Broker (as its counterparty for the PB/ED SBS), be responsible for Rules 15Fh-3(a) (Counterparty status as eligible contract participant and special entity) and 15Fh-3(e) (Know your counterparty), which it would satisfy through its bilateral documentation with the Prime Broker. Other external business conduct obligations would not apply as between the Prime Broker and the Executing Dealer because they are both SBS dealers

External Business Conduct Rules – Allocation of Responsibility

- In No-Action Letter No. 13-11, the CFTC addressed the parallel issues raised under its swap dealer external business conduct rules by permitting a Prime Broker and Executing Dealer to allocate the relevant external business conduct obligations between each other if, among other requirements:
 - All the external business conduct obligations that may be allocated, are allocated;
 - The Customer is provided with notice of the allocation;
 - The allocation is in writing; and
 - The Prime Broker and each Executing Dealer retain appropriate records

External Business Conduct Rules – Allocation of Responsibility (Cont'd)

If the SEC adopted an approach consistent with CFTC No-Action Letter No. 13-11, then we would expect Executing Dealers and Prime Brokers to allocate responsibility for external business conduct obligations owed to the Customer as follows:

Rule	Allocation
Rule 15Fh-3(a): Counterparty status as eligible contract participant and special entity	Prime Broker would be solely responsible
Rule 15Fh-3(b): Disclosure	Prime Broker would provide the Customer with standardized, relationship-wide disclosure; Executing Dealer would, before entering into a PB/ED SBS, provide the Customer with trade-specific disclosure and disclosure regarding any material incentives or conflicts of interest particular to the Executing Dealer
Rule 15Fh-3(c): Daily mark	Prime Broker would be solely responsible
Rule 15Fh-3(d): Disclosure regarding clearing rights	Prime Broker would provide the required disclosure to the Customer; no specific disclosure would be required for the Executing Dealer because SBS prime brokerage arrangements only apply to SBS that the Customer has elected not to clear
Rule 15Fh-3(e): Know your counterparty	Prime Broker would be solely responsible
Rule 15Fh-3(f): Recommendations of SBS or trading strategies	Executing Dealer would be entitled to rely on representations made by the Customer to the Prime Broker

External Business Conduct Rules – Allocation of Responsibility (Cont'd)

If the SEC adopted an approach consistent with CFTC No-Action Letter No. 13-11, then we would expect Executing Dealers and Prime Brokers to allocate responsibility for external business conduct obligations owed to the Customer as follows (continued from previous slide):

Rule	Allocation
Rule 15Fh-3(h): Fair and balanced communications	The Prime Broker and the Executing Dealer would each be responsible for their own communications
Rule 15Fh-4: Special requirements for SBS dealers acting as advisors to special entities	Executing Dealer would be entitled to rely on representations made by the Customer to the Prime Broker
Rule 15Fh-5: Special requirements for SBS dealers acting as counterparties to special entities	Prime Broker would be solely responsible
Rule 15Fh-6: Political contributions by certain SBS dealers	Prime Broker would be solely responsible

Application of Reporting Rules

- SBS prime brokerage involves two transactions:
 - The PB/ED SBS; and
 - The Customer Mirror SBS
- Absent relief, both transactions would be subject to reporting and public dissemination requirements
 - These requirements for the PB/ED SBS would be triggered when the SBS is executed by the Customer (acting as agent for the Prime Broker) and the Executing Dealer
 - These requirements would be triggered for the Customer Mirror SBS when it is automatically executed by virtue of the Prime Broker's acceptance of the PB/ED SBS

Application of Reporting Rules – Public Dissemination Issues

- Publicly disseminating the Customer Mirror SBS would be misleading from a transparency perspective because it does not reflect currently available market pricing or liquidity
- Because the SBS prime brokerage market is relatively small, addressing this issue by including a condition flag when publicly disseminating the Customer Mirror SBS could compromise transactional anonymity, thereby increasing costs for Customers and Prime Brokers
- Such dissemination also would not provide transparency as to the price of prime brokerage intermediation services because prime brokerage fees are not typically included in the price of a Customer Mirror SBS
- Similar considerations led the SEC to prohibit public dissemination of SBS resulting from the post-trade allocation of a bunched order, which we believe it should also do for Customer Mirror SBS