FINRA Proposes Guidance With Respect to International Prime Brokerage Transactions Effecting United States Executing Brokers, Prime Brokers and Custodians

by Paul B. Uhlenhop

In Regulatory Notice 07-58, November 2007 ("Notice"), Financial Industry National Regulatory Association ("FINRA") solicited comments on its proposed guidance regarding international prime brokerage practices. Because of the explosion of global trading and electronic system interconnectivity, this proposed guidance is important not only for international prime brokerage firms, but any firm that participates in international prime brokerage transactions, including executing brokers, prime broker custodians and customers because it sets forth a structure and details about what FINRA expects from a regulated member. Although this is a proposed guidance, it is a sound list of things that should be covered in the supervisory and operating procedures of the international prime brokerage custodian, the executing broker and any member of FINRA, or any other customer engaged in prime brokerage, such as a hedge fund.

Unfortunately, the guidance proposed by FINRA only discusses one prime brokerage scenario and does not cover a multitude of other scenarios and practices in international prime brokerage. The proposed guidance also does not spell out the status of other international prime brokerage scenarios under SEC Rule 15a-6[1] and the no-action letters that have been granted by the staff relating to exemptions for foreign prime brokers, foreign executing brokers and international prime brokerage custodians and others that participate in international prime brokerage transactions.

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The Proposed Guidance

The proposed guidance extends the existing requirements set forth in the SEC's prime brokerage no-action letter of January 25, 1994 to the SIA Prime Brokerage Committee (the "Prime Brokerage No-Action Letter") to international prime brokerage transactions as set forth in the one scenario posited in the Notice. The Notice provides guidance

relating to: (1) account arrangement; (2) delivery instructions; (3) affirmation of trades; (4) books and records; (5) documentation; (6) confirmation of trades; (7) notification; and (8) net capital.

The Notice discusses only the following scenario. A foreign domicile customer of a foreign domicile prime broker ("FPB") executes a transaction through an executing broker-dealer ("EB") that is a member of FINRA. The FPB would also presumptively include foreign domicile banks operating as foreign broker-dealers. The FPB is an affiliate of an international prime broker custodian ("IPBC") that is a member of FINRA and that proposes to clear and settle the foreign customer trade. The Notice posits that the "securities transactions are subject to the applicable federal securities laws."

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Account Arrangement

The guidance suggests that the IPBC should have an omnibus cash account agreement with the FPB for the aggregate of all trades of the customers of the FPB. The IPBC member will be responsible for affirmation and settlement for the customer transactions of the FPB pursuant to the arrangement. Both the IPBC and the EB will be responsible for Reg SHO compliance. The documentation that FINRA suggests in this proposed guidance is discussed below.

Delivery Instructions

With respect to delivery instructions, it suggests that the United States EB will direct settlement of the transactions to the DTC account of the IPBC which will settle the transaction on behalf of its affiliated FPB.

Affirmation of Trades

The Notice discusses confirmation (affirmation), disaffirmation and DKs of trades using the "Omega TradeSuite/CNS Interface for Prime Brokers." The customer by T + 1, is to notify the FPB of the trade which is to be relayed by the FPB to the IPBC, sent within certain time frames as is the practice under domestic prime brokerage. The IPBC will either affirm, disaffirm or DK the trade after receipt of notice. In addition, consistent with the current Prime Brokerage No-Action Letter, the IPBC can disaffirm a previously affirmed trade under certain time frames and conditions. It is important to note that if the trade is disaffirmed or DK'd, then the transaction will be treated as a customer transaction of the member EB. What this means, as in domestic prime brokerage, is the EB must have complete customer documentation for the foreign customer that gives the EB the order. If the disaffirmed or DK'd trade is a short sale, the EB member must treat the transaction as if it had been executed in a customer margin account. As discussed under Account Documentation, account documents must cover all of the above details. The guidance fails to note that the EB being a member of FINRA dealing with a foreign customer would also need to comply with or be exempt from the law of the domicile of the foreign customer.

Books and Records

With respect to books and records, the IPBC is required to establish an omnibus cash account in the name of the FPB for the benefit of its customers. The account will contain in aggregate all of the trades of the prime broker's customers. Does this also include United States customers of the FPB or is a separate cash omnibus account necessary for domestic customers? The guidance assumes the account will be paid in full on settlement date after which the FPB then may withdraw fully paid securities from the omnibus account.

Importantly, the cash omnibus account should be treated as a customer account by the IPBC for purposes of SEC Rule 15c3-3 and the secu-

rities are subject to the possession and control and the customer reserve computation requirements. Credit balances pertaining to short sales are required to remain in a *separate* omnibus margin account at that IPBC in the name of the foreign prime broker because the Notice suggests customers of foreign prime brokers do not normally require a margin deposit according to the Notice. However, this is contrary to the author's experience, particularly with respect to foreign prime brokers operating in the European Union where margin is required for certain customers and transactions.

Account Documentation

The guidance provides for use as base documents SIFMA Forms 150 and 151 which are used with domestic prime brokerage. However, the Notice states that they need to be revised for international prime brokerage. It does not specifically state what revisions are necessary, but it is the author's understanding that various non-uniform addendums to both Forms 150 and 151 are in use by firms involved in international prime brokerage. The guidance states that Form 150 with appropriate revisions should be executed between the IPBC and the EB. In addition, the IPBC and the FPB should enter into a separate international prime brokerage agreement specifying their respective responsibilities and obligations.

The Notice states that the FPB should also have an agreement with its prime brokerage foreign customers but does not discuss any details about what it should cover. This should be controlled by the law of the FPB customer domicile but consistent with the procedures, obligations and agreements in Forms 150 and 151. The EB and its foreign prime brokerage customers should also have an agreement such as a revised SIFMA Form 151 which specifies the obligations and responsibilities of the parties regarding international prime brokerage arrangement.

If the EB is an introducing broker, it is required to inform its clearing firm that it intends to act as an EB in an international prime brokerage relationship. There should also be an agreement executed between the introducing EB and its clearing firm that specifies the obligations of each party in the international prime brokerage arrangement. Most clearing agreements between a United States introducing broker and its clearing firm provide specifically what type of prime brokerage, if any, will be allowed and prohibit an introducing EB from prime brokerage without a appropriate agreements. Clearing firms should have an agreement similar to that which is currently used for domestic prime brokerage with its introducing broker, but it would need revisions to cover the other obligations and responsibilities incident to international prime brokerage.

Confirmations

The Notice states that the EB should send *directly* to the prime brokerage customer a confirmation complying with SEC Rule 10b-10 for each trade placed with the EB pursuant to the prime brokerage relationship. Alternatively, as in the case with domestic transactions, the EB may send the confirmation to the prime broker customer in care of the FPB if instructed to do so by the customer in writing. On the date following the trade date of the transaction, the FPB is required to send to its customer a notification of each trade placed with the EB under a prime broker arrangement based on information provided by the foreign prime brokerage customer. This presents various issues that need to be resolved because a FPB will have its own regulatory scheme confirmation requirements which may or may not complement Rule 10b-10. In fact, the FPB will likely have to comply with the foreign regulatory requirements and the separate requirements of the foreign customer's jurisdiction.

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Notification of DEA

As in any prime brokerage arrangement, there is a requirement that there be a notification of the arrangement by the IPBC and the EB to their respective designated examining authority.

Net Capital

As required by the Prime Brokerage No-Action Letter, a member firm acting as an IPBC must have net capital of at least $1.5 million and the EB (or if an introducing EB, its clearing firm) should have net capital of at least $1 million.

Foreign Law and Regulatory Requirements

The FINRA release does not discuss the possible impact and conflicts on the EB, FPB or the IPBC under the foreign law of the domicile of the FPB or the FPB customer. For example, the law of the FPB may require the FPB to either maintain funds in its cash reserve or similar client fund account in a foreign depository as required under the foreign domicile regulatory scheme. Notwithstanding the foreign requirement to maintain client funds in an offshore depository, Rule 15c3-3 may also require the IPBC to maintain funds in its reserve account under SEC Rule 15c3-3. Also, the example does not posit whether the securities involved are securities of foreign issuers (foreign securities) which may be traded in the United States or whether they are United States issuer securities which may be traded in the United States. Hopefully this will be discussed but probably not resolved in the final guidance.

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SEC Rule 15a-6

The Notice also does not discuss SEC Rule 15a-6 and its impact on the IPBC, the EB, the FPB, or the foreign customer. Neither SEC Rule 15a-6 nor the proposing or adopting releases specifically discuss international prime brokerage, except in an intangible way with respect to the general principles underlying the release. Various no-action letters discuss certain scenarios involving international foreign broker-dealers and U.S. institutional type customers. However, the scenarios discussed in those letters do not cover other numerous scenarios and practices that have evolved in international prime brokerage over recent years. The status of the international prime brokerage scenario presented in the proposed guidance is probably covered by an exception in SEC Rule 15a-6(a)(1). However, the status of other international prime brokerage scenarios is not clear under SEC Rule 15a-6. SEC Rule 15a-6 no-action letters are helpful with respect to certain other types of transactions.[2] In one no-action letter scenario, an institutional customer of a United States broker-dealer executes directly with a foreign domicile broker-dealer that is an affiliate of a United States broker-dealer a transaction in foreign issuer securities. The transaction may be executed and settled directly by the United States institutional customer with the foreign broker-dealer rather than executing and settling the transaction through its affiliated United States broker-dealer (which is also permitted). But this is conditioned on the foreign broker-dealer being an affiliate of the United States broker-dealer with whom the institutional client has an account and the United States broker-dealer "intermediating" the transaction as required under Rule 15a-6(a)(3). If the United States broker-dealer is a custodian for the United States customer, the securities could then be held by the foreign broker-dealer as a prime broker custodian or transferred to its United States affiliate as a prime broker-dealer custodian. Many firms also interpret this series of no-action letters to permit a non-affiliate to act as a foreign EB for a United States customer so long as a United States broker-dealer intermediates the transaction.

The scenario posited in the Notice does not deal with numerous other types of international prime brokerage transactions. A frequent scenario is a foreign institutional customer who executes a transaction with a United States broker-dealer in either United States issuer securities or foreign securities with the transaction being settled and

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Privilege Issues

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Independent Directors Council Mutual Funds Compliance Programs Conference § 2 (June 28, 2004), available at www.sec.gov/news/speech/spch0630041ar.htm.

[10] *United States v. United States Shoe Machinery Corp.*, 89 F. Supp. 357, 358-59 (D. Mass. 1950). See also, *Upjohn Co. v. United States*, 449 U.S. 383 (1981).

[11] *Hickman v. Taylor*, 329 U.S. 495 (1947).

[12] *In re Kidder Peabody Securities Litigation*, 168 F.R.D. 459 (S.D.N.Y. 1996).

[13] See Rule 38a-1 under the 1940 Act; Rule 206(4)-7 under the Advisers Act.

[14] *See, Compliance Programs of Investment Companies and Investment Advisers*, 1940 Act Release No. 26,299, at n. 94 (Dec. 17, 2003).

[15] Lori A. Richards, Director, OCIE, *Speech by SEC Staff: The New Compliance Rule: An Opportunity for Change*, presented at ICI/Independent Directors Council Mutual Funds Compliance Programs Conference § 2 (June 28, 2004), available at www.sec.gov/news/speech/spch063004lar.htm.

[16] Kevin Burke, *CCOs Feeling Heat From Examiners: Fielding Inquiries A Sizeable Burden*, MONEY MGMT. EXECUTIVE, Apr. 18, 2005 (quoting John Walsh, Chief Counsel, OCIE).

[17] See *infra* section V.B.

[18] Lori A. Richards, Director, OCIE, Testimony Before the U.S. House Subcommittee on Commercial and Administrative Law (June 7, 2005), available at www.sec.gov/news/testimony/ts060705lar.htm ("Richards Testimony"); United States Government Accountability Office Report, Mutual Fund Trading Abuses: Lessons to Be Learned from the SEC not Having Detected Violations at an Earlier Stage, at 35 (Apr. 2005).

[19] *Id.*

[20] Letter from Lori A. Richards, Director, OCIE, to Richard J. Hillman, Director, Financial Markets and Community Investment, GAO (Apr. 1, 2005).

[21] United States Government Accountability Office, *Securities and Exchange Commission: Steps Being Taken to Make Examination Program More Risk-Based and Transparent* (Aug. 2007).

[22] See Form 1661, *Supplemental Information for Regulated Entities Directed to Supply Information other than through a Commission Subpoena* (rev. 055-04).

[23] 17 C.F.R. 203.83.

[24] As discussed below in section V.B., however, this argument has been unsuccessful in most cases in which it has been addressed.

[25] *Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions*, Securities Exchange Act Release No. 44969(Oct. 23, 2001), available at: http://www.sec.gov/litigation/investreort/34-44969.htm.

[26] Linda Chatman Thomson, Director, SEC Division of Enforcement, *Remarks Before the 27th Annual Ray Garrett, Jr. Corporate and Securities Law Institute 2007* (May 4, 2007), available at: http://www.sec.gov/news/speech/2007/spch050407lct.htm ("Chatman Speech").

[27] *Enforcement: SEC Top Enforcer Thomsen Urges Lawyers to Show 'Professional Courage,"* SECURITIES LAW DAILY, May 7, 2007, at D9.

[28] Commissioner Atkins has been particularly outspoken on this subject. He has stated that the SEC should not give cooperation credit for waiver of attorney-client privilege, because it is tantamount to punishing companies for not waiving the privilege. Paul S. Atkins, Commissioner, *Remarks at the Federalist Society Lawyers' Chapter of Dallas, Texas* (Jan. 18, 2008), available at http://www.sec/gov/news/speech/2008/spch011808psa.htm; Paul S. Atkins, Commissioner, *Remarks Before the Federalist Society* (Sept. 21, 2006), available at http://www.sec/gov/news/speech/2006/spch02106psa.htm.

[29] See Chatman Speech, note 26 *supra*.

[30] Department of Justice prosecutors may give cooperation credit for waiving privilege, which may be a further consideration when an inspection involves possibly criminal conduct.

[31] House Report, 110-445.

[32] *Compare Diversified Industries, Inc. v. Meredith*, 572 F.2d 596, 611 (8th Cir. 1978) (en banc) (disclosure of protected materials to SEC during a formal investigation did not waive privilege in subsequent civil litigation), *with In re Steinhardt Partners, LP*, 9 F.3d 230, 235 (2d Cir. 1993) (voluntary submission to SEC of memorandum prepared at the SEC's request SEC constituted a waiver of privilege as to third parties).

[33] *In re Qwest Communications International Inc.*, 450 F.3d 1179 (10th Cir.), *cert. denied*, 127 S.Ct. 584 (2006).

[34] 2007 WL 495150 (S.D.N.Y. Jan. 26, 2007).

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cleared through a foreign prime broker-dealer custodian, including a foreign bank custodian. Another common scenario is when a United States institutional customer uses a foreign domiciled broker-dealer, bank or custodian for prime brokerage and executes either in the United States or offshore transactions which are cleared and settled by the foreign domiciled clearing prime broker (or bank) acting as custodian. This scenario is used by hedge funds from time to time. These transactions may be executed by the United States institutional account with foreign executing brokers or they may be executed with members and given up to the foreign domiciled clearing broker and custodian. These are only a few of the multiple scenarios that can occur with international prime brokerage that should be discussed.

Conclusion

All in all, the Notice is a step forward because it raises a host of issues that have long been dormant notwithstanding the explosion of global trading and global prime brokerage arrangements. However, the discussion is far too limited but does provide a specific list of procedures that should be used as a guide for other transactions not discussed in the Notice. Further, it should involve the SEC providing clear guidance under Rule 15a-6 for the multitude of types of international prime broker transactions that occur using not only United States IPBCs, but foreign IPBCs, foreign EB and United States EBs with either United States customers or foreign customers. The discussion should also deal with the conflict of law inherent in international relations between the regulatory schemes of the foreign participants and custom-

ers in relationship to the United States regulatory scheme for its broker-dealers and customers. The interplay of the various elements is an enormously complex subject and involves the laws and regulatory schemes of many countries as well as the differing bankruptcy schemes which are important to protecting customer funds and securities.

SIFMA should be involved, as well as similar industry organizations in foreign countries to develop international prime brokerage agreements similar to SIFMA Forms 150 and 151 used so successfully in the United States for prime brokerage arrangements. An international agreement such as this necessarily will involve various offshore regulators and trade organizations. The futures industry has developed international electronic give-up agreements for futures give-ups that are the equivalent of the securities industry prime brokerage agreements. The author would urge SIFMA, the SEC and FINRA to develop such agreements, and provide that they may be executed electronically.

ENDNOTES

1 15a-6; 17 CFR §240.15a-6.

2 *See e.g.*, SEC no-action letters Cleary, Gottlieb, Steen & Hamilton, April 9, 1997.