

International Prime Brokerage

FINRA Solicits Comments on Proposed Guidance Regarding International Prime Brokerage Practices

Comment Period Expires: January 10, 2008

Executive Summary

Given the growth of the international prime brokerage (IPB) business, FINRA recently interviewed representatives from many of the largest prime brokerage firms to determine how this business is conducted. The interviews covered the various practices used by the prime brokers and how they differed from practices used in domestic prime brokerage, as outlined in the SEC's 1994 No-Action letter.¹ For purposes of this *Notice* and the Proposed Guidance, international prime brokerage is defined as the practice whereby a foreign domiciled customer executes transactions through a member firm (the executing broker) that are settled and carried by another member (the international prime brokerage custodian) on behalf of its affiliated foreign broker-dealer (the foreign prime broker or FPB).

FINRA's review found inconsistencies between member firms with regard to legal documentation/agreements, settlement practices, books and records, and other areas important in defining the roles and obligations of the parties when a prime broker customer (who is generally foreign domiciled) purchases or sells U.S. securities with a foreign prime broker and a U.S. executing broker.

In an attempt to establish consistency among our member firms, share best practices, and apply fair and consistent standards to all firms that are active in this business, FINRA is soliciting comments from member firms and other interested parties on our Proposed Guidance regarding the IPB practices described herein.

As outlined in Attachment A, the Proposed Guidance extends the existing requirements set forth by the SEC in the 1994 No-Action letter to IPB transactions 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.

November 2007

Notice Type

- Request for Comment

Suggested Routing

- Compliance
- Legal
- Operations
- Senior Management

Key Topic(s)

- Foreign prime broker
- International Prime Brokerage

Referenced Rules and Notices

- SEC 1994 No-Action letter on prime brokerage
- SEC Rule 15c3-3
- SEC Rule 10b-10
- Reg SHO

Questions regarding this *Notice* should be directed to Bernadette Chichetti, Senior Principal Associate, Risk Oversight & Operations Regulation (RO&OR), at (212) 656-6934; or Yui Chan, Managing Director, RO&OR, at (212)656-8115.

Request for Comments

FINRA encourages all interested parties to comment on the Proposed Guidance. Comments must be received by January 10, 2008. Members and other interested parties can submit their comments using the following methods:

- Mailing comments in hard copy to the address below; or
- Emailing comments to *pubcom@finra.org*.

To help FINRA process and review comments more efficiently, you should only use one method to comment on this proposal; however, if you wish to submit comments using more than one of the methods listed above, you should indicate that in the submissions.

Comments sent by hard copy should be mailed to:

Barbara Z. Sweeney
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, DC 20006-1506

Important Notes: The only comments that will be considered are those submitted pursuant to the methods described above. All comments received in response to this *Notice* will be made available to the public on the FINRA Web site. Generally, comments will be posted on the FINRA Web site one week after the end of the comment period.²

Endnotes

1. See SEC No-Action letter of January 25, 1994 to SIA Prime Broker Committee.
2. Personal identifying information, such as names or email addresses, will not be edited from submissions. Submit only information that you wish to make publicly available. See *Notice to Members 03-73* (November 2003) (Online Availability of Comments) for more information.

ATTACHMENT A

International Prime Brokerage (IPB) Definitions:

- Foreign prime broker (FPB) is a foreign broker-dealer.
- Prime Broker Customers are foreign domiciled (PB customers).
- International Prime Broker Custodian (IPBC) is a carrying/clearing member which is an affiliate of and acts as custodian for the FPB in these international prime broker transactions.
- Executing broker (EB) is a member.
- Securities transactions are subject to applicable federal securities laws.

Proposed Guidance for IPB Best Practices

1. ACCOUNT ARRANGEMENT

The IPBC should enter into an omnibus cash account agreement with its FPB to establish an IPBC account for the aggregate trades of all the PB customers of the FPB. The IPBC will be responsible for affirmation and settlement for the PB customer transactions of the FPB and both the IPBC and the EB will be responsible for Reg. SHO compliance.

2. DELIVERY INSTRUCTION

The EB will direct the settlement of the transactions to be effected in the DTC account of the IPBC, which will settle the transactions on behalf of the FPB.

3. AFFIRMATION OF TRADES

The EB will confirm the trades, via the “Omgeo TradeSuite/CNS Interface for Prime Brokers,” with the IPBC. The PB customer, by T+1, will notify the FPB of the particulars of the trade. This data is then relayed by the FPB to the IPBC.

The IPBC, upon receipt of the trade data from the “Omgeo TradeSuite/CNS Interface for Prime Brokers,” will either affirm or DK the trade with the EB. In addition, consistent with the provisions of the 1994 No-Action letter,¹ the IPBC can disaffirm a previously affirmed trade. If the IPBC disaffirms or DKs a trade, then the transaction will continue to be treated as a customer transaction on the books of the EB. If the disaffirmed or DKed trade is a short sale, the EB will treat the transaction as if it had been executed in a customer margin account.

4. BOOKS & RECORDS

As stated above, the IPBC will establish an omnibus cash account in the name of the FPB on its books and records. This account will contain, in aggregate, all the trades for the PB customers of the FPB. On settlement date, this account should be paid in full. There are no restrictions on the FPB from withdrawing fully paid securities from this account.

Furthermore, the cash omnibus account established in the name of the FPB should be treated as a customer account by the IPBC for purposes of SEC Rule 15c3-3² and, thus, should be subject to the possession or control and customer reserve formula computation requirements of the rule. However, credit balances pertaining to any short sales should remain in a separate omnibus margin account in the name of the FPB in order to protect the IPBC from customer risk, as PB customers typically do not deposit margin with the FPB as customers of a foreign broker-dealer are exempt from the requirements of FRB Regulation T³ and other margin-related regulations. The FPB may enter into a separate securities borrowed transaction to cover the short sales in the margin omnibus account.

5. DOCUMENTATION

- Revised Form 150: Instead of an agreement between the FPB and EB, the IPBC should execute SIFMA Form 150 on International Prime Brokerage (SIFMA Form 150 may need to be revised) with the EB. In addition, the IPBC and its FPB should enter into a separate IPB agreement that specifies the obligations and responsibilities of each party in this custodian arrangement.
- Agreement between FPB and its PB Customers: The FPB should have an agreement with its PB customers.
- Revised Form 151: Agreement between the EB and its PB Customers: The EB should have an agreement (SIFMA Form 151 may need to be revised) with its customers that specifies the obligations and responsibilities of the parties regarding the IPB arrangement.
- Agreement between Introducing EB and its Carrying/Clearing Member: If the EB is an introducing member, it should inform its carrying/clearing firm that it intends to act as an EB in an IPB relationship. Furthermore, a contract must be executed between the introducing EB and its carrying/clearing member that specifies the obligations and responsibilities of each party in the IPB arrangement.

6. CONFIRMATION OF TRADES

The EB should send directly to the PB customer of the FPB a confirmation of each trade placed with the EB pursuant to this prime broker arrangement. Such confirmation should comply with the specific requirements of SEC Rule 10b-10.⁴ Alternatively, the EB may send the confirmation to the PB customer in care of the FPB if the PB customer has instructed the EB to do so in writing through an instrument separate from the prime broker agreement. In addition, on the day following the transaction, the FPB should send to the PB customer a notification of each trade placed with the EB under a prime broker arrangement, based upon information provided by the PB customer.

7. NOTIFICATION

The IPBC should notify its designated examining authority (DEA) in writing within thirty days from the date of issuance of the final guidance if it intends to act as an IPBC. In addition, any member firm intending to act as the EB in an IPB arrangement should provide written notice to its DEA prior to commencing such activity.

8. NET CAPITAL

- A member firm acting as an IPBC should have net capital of at least \$1,500,000.⁵
- A member firm acting as an EB clearing international prime broker transactions or a member firm clearing international prime broker transactions on behalf of an introducing EB should have net capital of at least \$1,000,000.⁶

Endnotes

1. See SEC No-Action letter of January 25, 1994 to SIA Prime Broker Committee.
2. 17 CFR 240.15c3-3
3. 12 CFR 220.1
4. 17 CFR 240.10b-10 and see SEC No-Action letter of January 25, 1994 to SIA Prime Broker Committee.
5. See SEC No-Action letter of January 25, 1994 to SIA Prime Broker Committee.
6. See Id.