



DIVISION OF  
MARKET REGULATION

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

January 25, 1994

Mr. Jeffrey C. Bernstein  
Prime Broker Committee  
c/o Bear, Stearns & Co., Inc.  
One Metrotech Center North  
Brooklyn, NY 11201

**Re: Prime Broker Committee Request**

Dear Mr. Bernstein:

This is in response to your letter dated September 13, 1989 on behalf of the Prime Broker Committee<sup>1</sup> in which you requested the views of the Division of Market Regulation of the Securities and Exchange Commission ("Division") and the Division of Banking Supervision and Regulation of the Board of Governors of the Federal Reserve System ("FRS Division") regarding the applicability of Sections 7, 10, 11(d), 15(c)(3) and 17 of the Securities Exchange Act of 1934 ("Exchange Act")<sup>2</sup> and Regulation T<sup>3</sup> thereunder, and Rules 10a-1, 10b-10, 11d1-1, 15c3-1 and 15c3-3 under the Exchange Act<sup>4</sup> to prime broker arrangements.<sup>5</sup>

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<sup>1</sup> We understand that the Prime Broker Committee consists of representatives from prime brokers and executing brokers and the Credit Division of the Securities Industry Association. The Committee was organized to review and evaluate the operation of prime broker arrangements and recommend appropriate changes to regulations in order to clarify the responsibilities and obligations of the various parties.

<sup>2</sup> 15 U.S.C. §§ 78g, 78j(b), 78k(d) & 78o(c)(3).

<sup>3</sup> 12 C.F.R. Part 220.

<sup>4</sup> 17 C.F.R. §§ 240.10a-1, .10b-10, .11d1-1, .15c3-1 & .15c3-3.

<sup>5</sup> This letter discusses some of the most significant provisions applicable to the prime broker arrangement. Nevertheless, it is the responsibility of the parties to a prime broker arrangement to comply with all applicable provisions of the securities laws and regulations.

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## **I. Background**

On the basis of your letter, and subsequent conversations, we understand the facts to be the following.

Prime brokerage is a system developed by full-service firms to facilitate the clearance and settlement of securities trades for substantial retail and institutional investors who are active market participants. Prime brokerage involves three distinct parties: the prime broker, the executing broker, and the customer. The prime broker is a registered broker-dealer that clears and finances the customer trades executed by one or more other registered broker-dealers ("executing broker") at the behest of the customer. Each of the executing brokers receives a letter from the prime broker agreeing to clear and carry each trade placed by the customer with the executing broker where the customer directs delivery of money or securities to be made to or by the prime broker.

The customer maintains its funds and securities in an account with the prime broker. Orders placed with the executing broker are effected through an account with the executing broker in the name of the prime broker for the benefit of the customer. When a customer places a trade order ("trade date"), the executing broker buys or sells securities in accordance with the customer's instructions. On trade date, the customer notifies the prime broker of the trade performed by the executing broker. The transaction is recorded in the customer's cash or margin account with the prime broker. At the same time, the prime broker records the transaction in a "fail-to-receive/deliver" account with the executing broker.

The prime broker issues a confirmation or notification to the customer and computes all applicable credit and Regulation T amounts. The executing broker confirms the transaction with the prime broker through the Depository Trust Company's Institutional Delivery System. The prime broker then will affirm the trade if its information matches successfully with the information received from the executing broker. The trade may then be submitted to the National Securities Clearing Corporation for clearance and settlement following normal settlement procedures. The prime broker then settles with the customer in the normal way.

The prime broker issues a statement of account to its customer at least on a monthly basis. The statement includes all security transactions during that period and the resultant customer security positions and money balances.

The Prime Broker Committee believes that this arrangement is advantageous to prime brokerage customers because the prime broker acts as a clearing facility and accountant for all of the customer's security transactions wherever executed as well as a central custodian for the customer's securities and funds.

## **II. Prime Broker Committee Proposal**

The Prime Broker Committee has proposed that, for purposes of Regulation T, transactions effected for the customer, between the executing broker and the prime broker, should be deemed broker-to-broker transactions after completion of the affirmation process. The Prime Broker Committee also has proposed that, (i) prior to the commencement of any prime brokerage activity, the prime broker send a letter to the executing broker authorizing the executing broker to accept orders from the customer, which will be settled by the prime broker, and (ii) the prime broker should have two business days to disaffirm trades before it must accept settlement responsibility for trades executed on behalf of its prime broker clients.

The Prime Broker Committee believes that providing the prime broker with two business days to disaffirm trades before finally accepting settlement responsibility for trades executed on behalf of customers is necessary to allow prime brokers sufficient time to review and ensure, among other things, that the trade is within the credit limits established for the customer's account. In the event the prime broker disaffirms a trade, the executing broker would be precluded from asserting that the prime broker, whose name had been "given up" by the customer, but who had no knowledge of a particular trade at the time it was effected, should be the responsible party for consummating settlement of the transaction. Moreover, disaffirmed trades would be treated as customer transactions on the books of the executing broker, and, therefore, subject to the provisions of Regulation T. Since the trade could be disaffirmed by the prime broker, the Prime Broker Committee believes that the executing broker would be compelled to fulfill its compliance responsibilities with respect to the particular transaction and customer.

## **III. Discussion**

The relationships described in your letter, as outlined above (*i.e.*, "prime brokerage" or "prime broker arrangement"), raise several questions under the Exchange Act. After analyzing current practices, the Division and the FRS Division have determined that there is a need to clarify the obligations and responsibilities under the Exchange Act of each of the parties involved in prime brokerage. The following is a discussion of the application of the margin and credit regulations and the customer

confirmation, short sale, customer protection, and net capital provisions to prime brokerage.

A. Regulation T

Regulation T requires a broker or dealer to record all transactions with a single person in a margin account unless specifically authorized for inclusion in another account.<sup>6</sup> Securities transactions effected for a customer of a prime broker should be recorded in a margin account or, where permitted, a cash account. Regulation T currently requires the executing broker to treat the customer as its own customer and record the transaction in a cash or margin account at that firm since it can be said that the executing broker is extending or arranging for the extension of credit to the customer until at least settlement date. The executing broker, however, generally settles prime brokerage transactions following normal settlement procedures through the prime broker's account at the executing broker, which is designated as a broker-dealer credit account. This method appears to regard the customer as an agent of the prime broker for purposes of these transactions, and to disregard the creditor/customer relationship between the executing broker and the customer.

Normally, under Regulation T, if a customer's margin purchase or short sale is involved, the executing broker would have to determine whether a margin deposit is required in a margin account.<sup>7</sup> The required margin amount would have to be deposited in the customer's account at the executing broker within seven business days after the margin deficiency had been created.<sup>8</sup> Regulation T, moreover, would require that the executing broker liquidate securities in a margin account to meet a margin call or to eliminate any margin deficiency exceeding \$500, if a margin call is not met in full within the required time.<sup>9</sup>

If the transactions were effected in a cash account, the executing broker would be able to buy from or sell to the customer a security only under certain restrictive

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<sup>6</sup> 12 C.F.R. § 220.1(b)(1).

<sup>7</sup> 12 C.F.R. §§ 220.4(b), (c) & .5(a), (b) & (c).

<sup>8</sup> 12 C.F.R. § 220.4(c)(3).

<sup>9</sup> 12 C.F.R. § 220.4(d).

credit conditions.<sup>10</sup> Transactions in the cash account are predicated on the broker accepting in good faith the customer's agreement that all securities sold have already been paid for and all securities bought will be paid for before being sold.<sup>11</sup> In this account, full cash payment for any customer purchases generally must be made within seven business days of trade date.<sup>12</sup>

If the customer has not paid in full for securities before the securities are delivered to the prime broker, the account at the executing broker would be subject to a 90-day freeze.<sup>13</sup> Under prime brokerage as described in your letter, however, the customer never pays the executing broker, but rather the prime broker. If the account at the executing broker were a cash account, it would be "frozen" (i.e., securities purchases could be effected only if cash sufficient to pay for the securities is on hand prior to the execution of the trade) every time a security purchased is sent to the prime broker for payment by the customer.<sup>14</sup>

The 90-day freeze would not apply if the securities are delivered to the prime broker for deposit in a cash account which holds sufficient funds to pay for the delivered securities.<sup>15</sup> For this purpose, the executing broker would need to rely on a written statement from the prime broker specifying that sufficient funds are held in the customer's account at the prime broker to cover that particular trade ("letter of free funds").<sup>16</sup>

B. Section 11(d)(1)

Section 11(d)(1) of the Exchange Act prohibits a person who is both a broker and a dealer from directly or indirectly extending, maintaining, or arranging for the

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<sup>10</sup> See 12 C.F.R. § 220.8(a).

<sup>11</sup> 12 C.F.R. §220.8(a)(1) & (2).

<sup>12</sup> 12 C.F.R. § 220.8(b)(1).

<sup>13</sup> 12 C.F.R. § 220.8(c)(1).

<sup>14</sup> 12 C.F.R. § 220.8(c)(1).

<sup>15</sup> 12 C.F.R. § 220.8(c)(2).

<sup>16</sup> 12 C.F.R. § 220.8(c)(2)(ii).

extension or maintenance of credit on any security "which was part of a new issue in the distribution of which he participated as a member of a selling syndicate or group" within the prior thirty days. Generally, this means that, absent an exemption, a customer of a broker-dealer may not purchase a new issue security from or through that broker-dealer on credit for thirty days after the completion of the broker-dealer's participation in the offering as a member of the selling syndicate or group.

Absent the prime broker relationship, Rule 11d1-1(a) permits the customer's purchase of a security from a selling group member to be financed in a margin account of a second broker (even one involved in the distribution) if the second broker did not arrange the transaction. In a prime broker relationship in which the customer initiates the margin account with the prime broker, the customer generally can be viewed as having arranged for the credit provided through the margin account with the prime broker. Thus, where the prime broker is not a member of a selling group or syndicate, the prime broker's extension of credit for the purchase of the security through an executing broker who is a member of the syndicate is permissible as long as the credit extension was not arranged by the executing broker. Similarly, where the prime broker alone, or both the prime broker and the executing broker are members of the selling group or syndicate, the extension of credit for the purchase of the security from the executing broker is permissible absent an arranging of the credit by either broker.

Whether a financing has been impermissibly arranged is a question of fact. One example of such an "arranging" would be where a salesman of the prime broker that is a selling group member solicited a purchase order from a customer and, after being told by the customer that the customer wished to margin the purchase, the salesperson directed the customer to an executing broker knowing that the transaction would be financed in the customer's prime broker margin account. An impermissible arranging also would be present where an executing broker participating in a distribution arranged for the customer to establish a prime broker account at another broker-dealer to facilitate the financing of the security being distributed.

#### C. Customer Confirmations

Rule 10b-10 of the Exchange Act requires a broker or dealer, at or before the completion of a security transaction, to send its customer a confirmation of the trade.<sup>17</sup> The confirmation typically serves as an invoice and gives the customer an

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<sup>17</sup> 17 C.F.R. § 240.10b-10.

opportunity to verify and evaluate the details of the trade. The obligation to send the confirmation normally falls on the broker with whom the customer places the order since that broker generally has most of the information needed to comply with the disclosure requirements of the rule.

In the prime broker arrangement, the executing broker takes the order from the customer, yet the prime broker typically issues the confirmation. Consequently, the prime broker may not have all the information required to be on the confirmation by Rule 10b-10. Moreover, there appears to be uncertainty whether information regarding the executing broker must be included on the confirmation.

We believe that the executing broker is required to send to the customer a confirmation of each trade placed with the executing broker pursuant to the prime broker arrangement and such confirmation must comply with the requirements of Rule 10b-10. You indicate, however, that customers generally do not wish to receive individual confirmations directly from the executing broker, and would prefer to receive notification of transactions solely from the prime broker.

Thus, in lieu of the executing broker sending the confirmation directly to the customer, the executing broker would, based on written instructions from the customer, send such confirmation to the customer in care of its prime broker. Such written instructions to the executing broker would (i) explicitly request that the executing broker send the confirmation to the customer in care of its prime broker, (ii) be a separate instrument from the prime broker agreement, (iii) not be a condition of entering into a prime broker or executing broker arrangement, and (iv) not be induced by differential fees based on whether an instruction is provided. The prime broker would inform the customer in writing that the confirmation sent by the executing broker to the customer in care of the prime broker is available promptly from the prime broker upon request, at no additional charge.

On the day following the trade, the prime broker would send to the customer a notification of each trade placed with the executing broker pursuant to the prime broker arrangement, based on information provided by the customer. The prime broker would request in writing that the customer provide it with all the information required on confirmations by Rule 10b-10; however, the notification from the prime broker to the customer may omit the capacity of the executing broker, a designation of the trade price as an average price, and, in principal trades, the reported trade price and the difference between this price and the net price to the customer, if the customer fails to provide this information. The notification would clearly identify the executing broker and prime broker and their roles in the trade. If the prime broker

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charges a transaction-based fee, the notification would indicate the amount of the fee charged in the trade in addition to indicating any commission charged by the executing broker.

We note that, in addition to the specific requirements of Rule 10b-10, the general anti-fraud provisions of the securities laws require broker-dealers to disclose to their customers all facts that are material to the transaction.

#### D. Short Sales

Rule 10a-1 under the Exchange Act prohibits any person, for his account or for the account of another, from effecting a short sale of a security covered by the rule under the following conditions: (i) at a price below the price at which the immediately preceding sale was effected ("minus tick"), or (ii) at the last sale price if it was lower than the last preceding different price ("zero-minus tick").<sup>18</sup> Rule 10a-1(c) prohibits broker-dealers from effecting a sell order without marking the order either "long" or "short". The responsibility for compliance with these requirements must obviously rest with the executing broker.

The executing broker has the responsibility of ascertaining, from the prime broker or otherwise, that the shares will be available for borrowing in order to effect a timely delivery. The National Association of Securities Dealers, Inc. ("NASD") and the New York Stock Exchange, Inc. ("NYSE") require a member firm, prior to effecting a customer's short sale, to make an affirmative determination that the security is available or that it can borrow the security on behalf of the customer for delivery by the settlement date.<sup>19</sup> The prime broker also must be aware of the nature of the sale because short sales must be recorded in a margin account and margined in accordance with Regulation T.

#### IV. Response

The trading relationship currently in existence between the prime broker, the executing broker and the customer does not fit in any of the account structures of

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<sup>18</sup> 17 C.F.R. § 240.10a-1(a)(1)(i).

<sup>19</sup> See Section (b)(2) to the NASD Board of Governors Interpretation on Prompt Receipt and Delivery of Securities; NYSE Rule 440C, "Delivery Against Short Sales," Interpretation of .10/10 "Short Sale."



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Regulation T. The Division's staff believes that under the current terms of Regulation T, the account opened at the executing broker ("the Account") does not appear to be a broker-dealer credit account because there is a client relationship between the executing broker and the customer. However, based on the above discussion, after consultations with the FRS Division, and without necessarily agreeing with the legal conclusions set forth by the Prime Broker Committee in any of the various written and oral communications with the Division, as of six months from the date of this letter, the Division will not recommend that the Commission take enforcement action if, pursuant to a prime broker arrangement as discussed above, the executing broker and the prime broker treat the Account as if it were a broker-dealer credit account pursuant to Section 220.11 of Regulation T,<sup>20</sup> provided that the following conditions set forth below are met.<sup>21</sup>

1. A broker-dealer must notify its Designated Examining Authority ("DEA") that it intends to act as a prime broker.
2. A broker-dealer acting as a prime broker must have net capital<sup>22</sup> of at least \$1,500,000. A prime broker that is not in compliance with this provision must notify immediately all parties with whom it engages in prime brokerage activities, either individually or through the facilities of a clearing agency registered under Section 17A of the Exchange Act<sup>23</sup>.
3. Broker-dealers acting as executing brokers who clear prime broker transactions or broker-dealers clearing prime broker transactions on behalf of executing brokers must have net capital of at least \$1,000,000. An executing broker that is not in compliance with this provision must notify immediately all parties with whom it engages in prime brokerage activities, either individually or through the facilities of a clearing agency registered under Section 17A of the Exchange Act.

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<sup>20</sup> 12 C.F.R. § 220.11.

<sup>21</sup> Accordingly, if the conditions set forth in this letter are met, a letter of free funds would not be required for transactions in the Account that are paid for through the customer's account at the prime broker.

<sup>22</sup> See 17 C.F.R. § 240.15c3-1.

<sup>23</sup> 15 U.S.C. § 78q-1.

4. A prime broker may not settle prime broker trades on behalf of a customer, unless the customer keeps a minimum net equity with the prime broker of at least \$500,000 in cash or securities with a ready market.<sup>24</sup> If, as a result of fluctuations in the value of securities kept with the prime broker, the customer's net equity falls below the required minimum amount, the customer shall have until 12:00 noon of the fifth business day after the date when the net equity level fell below the required minimum amount to restore it to the \$500,000 level.

If the customer fails to do so, the prime broker settling trades on behalf of such customer will notify, by the close of business of the fifth day, all broker dealers (either individually or through the facilities of a clearing agency registered under Section 17A of the Exchange Act) with whom it has a prime broker contract on behalf of the customer that it is no longer acting as a prime broker for the customer. A prime broker must indicate that it does not know ("DK") any prime brokerage transaction commenced on behalf of the customer on the day after it has sent the notification required by this provision.<sup>25</sup>

A prime broker may settle prime broker trades on behalf of customer accounts managed by an investment adviser registered under Section 203 of the Investment Advisers Act of 1940,<sup>26</sup> if each account has a minimum net equity of at least \$100,000 in cash or securities with a ready market.

A prime broker may settle prime broker transactions on behalf of a customer who keeps a minimum net equity with the prime broker of at least \$100,000 in cash or securities with a ready market, if said account is subject to a binding, written contract providing for a cross-guarantee by another customer of the prime broker. Pursuant to this provision, a customer may cross-guarantee

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<sup>24</sup> 17 C.F.R. §240.15c3-1(c)(11) (defining the term "ready market").

<sup>25</sup> Until January 1, 1995 or such time as The Depository Trust Company's Institutional Delivery System is enhanced to support the possibility of DKs for trades, if later, for purposes of this provision, a prime broker utilizing the facilities of a clearing agency for the issuance of trade confirmations and affirmations may not affirm any prime brokerage transaction commenced on behalf of the customer on the day after it has sent the notification required by this provision.

<sup>26</sup> 15 U.S.C. § 80b-3.

another customer's account only if it keeps net equity with the prime broker of at least \$500,000 in cash or securities with a ready market. Cross-guarantees of other customers would require additional net equity of \$400,000 for each individual account that is cross-guaranteed. This provision does not affect a prime broker's obligations and responsibilities under Regulation T.<sup>27</sup>

5. Documentation

- A. Prior to the commencement of any prime brokerage activity, the prime broker and the executing self clearing firm or the clearing firm of an introducing broker acting as an executing broker must execute a contract that specifies the obligations and responsibilities of the parties regarding the prime broker arrangement.
- (i) The obligations and responsibilities set forth in the contract must be consistent with the conditions specified in this letter.
  - (ii) The contract must conform to the terms set forth in condition 8 below, and specifically set forth the executing broker's acknowledgement of its responsibility to know its customers, obtain all the proper documentation (including all new account documents), conduct its own credit checks, and determine the availability of shares to cover any short sales and process disaffirmed trades.
  - (iii) The contract must specify that, upon termination of the prime broker relationship with respect to a particular customer, the prime broker shall notify the executing brokers, whether individually or through the facilities of a clearing agency registered under Section 17A of the Exchange Act, that it is no longer acting as a prime broker for the customer.
- B. In addition to all written agreements necessary under the Federal securities laws and regulations, the prime broker and the executing broker, individually, must execute contracts with each customer on whose behalf the executing and the prime broker execute or settle prime brokerage transactions. Said contracts must be signed by the customer,

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<sup>27</sup> See 12 C.F.R. § 220.3(d).

and specify the obligations and responsibilities of the parties regarding the prime broker arrangement. The obligations and responsibilities set forth in these contracts must be consistent with the conditions specified in this letter.

- C. In cases involving introducing broker-dealers who act as executing brokers, the executing broker must inform each broker-dealer clearing its transactions that it intends to act as an executing broker.
  - (i) The executing broker and its clearing firm must execute a contract that specifies the obligations and responsibilities of the parties in the prime broker arrangement.
  - (ii) The obligations and responsibilities set forth in this contract must be consistent with the conditions specified in this letter.

The executing broker and the prime broker must keep in their possession copies of these contracts along with all other written agreements necessary to be able to execute or settle prime brokerage trades on behalf of customers. These documents must be kept in an easily accessible place and be produced upon request by the staff of the Commission or of any self-regulatory organization ("SRO") of which they are members.

- 6. The prime broker must keep separate records identifying all customers using the prime broker arrangement, along with the executing brokers employed by such customers. These separate records must be kept in an easily accessible place and be produced upon request by the staff of the Commission or of any SRO of which it is a member.
- 7. For all transactions, the customer and the executing broker must inform the prime broker of the contract amount, the security involved, number of shares or number of units, and whether the transaction was a long or short sale or a purchase, by the morning of the next business day after trade date.

Parties to a prime broker arrangement must utilize the facilities of a clearing agency registered under Section 17A of the Exchange Act for the issuance of trade confirmations and affirmations, provided, that such facilities comply with the provisions of this letter and, in particular, that confirmations are issued and received by the morning of the next business day after trade date.

8. The prime broker must be responsible to settle each of the customer's transactions placed with the executing broker and timely confirmed to and received by the prime broker in accordance with the provisions of condition 7 above, unless the prime broker disaffirms or DKs a particular transaction by no later than the close of business (as this term is defined by the corresponding clearing agency) of trade date plus one.<sup>28</sup> Accordingly, the executing broker must undertake its own credit review to ensure that it knows the customer as to these transactions.<sup>29</sup>

When utilizing the facilities of a clearing agency registered under Section 17A of the Exchange Act for the issuance of trade confirmations and affirmations, a prime broker may disaffirm or DK<sup>30</sup> a particular transaction before the close of business (as this term is defined by the corresponding clearing agency) of the day following the date when it receives a trade confirmation which was timely entered by the executing broker, if, due to unusual circumstances affecting the operations of the clearing agency (including, but not limited to, technical difficulties, natural disasters or power blackouts), the prime broker receives the trade confirmation for that particular transaction after 12:00 noon (eastern time) of trade date plus one. When necessary, a prime broker must disaffirm

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<sup>28</sup> In cases where trade data is corrected in the form of "as of" trades and the corresponding confirmation is received by the prime broker before noon, the prime broker must be responsible to settle such transaction placed with the executing broker, unless the prime broker disaffirms or DKs the trade by no later than the close of business (as this term is defined by the corresponding clearing agency) of the day when the prime broker receives the confirmation. If the confirmation is received after noon the prime broker will have until the close of business of the next business day to disaffirm or DK the trade.

<sup>29</sup> The ability to disaffirm is otherwise inconsistent with the structure of a broker-dealer credit account under the current language of Regulation T.

<sup>30</sup> Until January 1, 1995 or such time as The Depository Trust Company's Institutional Delivery System is enhanced to support the possibility of DKs for trades, if later, a prime broker utilizing the facilities of a clearing agency for the issuance of trade confirmations and affirmations will be responsible to settle customers' transactions placed with the executing broker, only when such trades have been affirmed but not disaffirmed in accordance with the time frames set forth in this condition.

or DK a particular transaction through the facilities of the clearing agency that issued the trade confirmation.

In all cases, if the prime broker receives a confirmation on a day when the major securities markets are closed, the prime broker shall have until the close of business (as this term is defined by the corresponding clearing agency) of the next day when the major securities markets are open to DK or disaffirm that trade.

9. The prime broker must keep a record that identifies all trades disaffirmed during the previous three years, specifying the identities of the executing broker and the customer for each trade.
  - A. This record kept by the prime broker identifying all trades disaffirmed during the previous three years must be kept in an easily accessible place and be produced upon request by the staff of the Commission or of the SRO of which they are members.
  - B. If the prime broker disaffirms or DKs a trade, then the transaction will continue to be treated as a customer transaction on the books of the executing broker. If the disaffirmed or DKed trade is a short sale, the executing broker will treat the transaction as if it had been executed in a customer margin account.
10. The executing broker must comply with all the applicable short sale provisions and, prior to the execution of any short sale, the executing broker must determine that securities can be borrowed to deliver against the short sale.
11. Pursuant to Rule 10b-10 under the Exchange Act, the executing broker must send directly to the customer a confirmation of each trade placed with the executing broker pursuant to the prime broker arrangement. Such confirmation must comply with the specific requirements of Rule 10b-10. Alternatively, the executing broker may send the confirmation to the customer in care of the prime broker if the customer has instructed the executing broker to do so in writing in an instrument separate from the prime broker agreement. Such an instrument must not be a condition for entering into the prime broker arrangement or executing trades through the executing broker, or be induced by differential fees based on whether an instruction is provided. The prime broker must inform the customer in writing that the confirmation sent by the

executing broker to the customer in care of the prime broker is available to the customer without charge promptly on request.

In addition, on the day following the transaction, the prime broker must send to the customer a notification of each trade placed with the executing broker pursuant to the prime broker arrangement, based on information provided by the customer. Such notification must include all the information required for confirmations by Rule 10b-10 except the capacity of the executing broker, an average price designation, and, in principal trades, the reported trade price and the difference between that price and the net price to the customer, if the customer fails to provide this information to the prime broker. Such notification also must disclose any transaction-based charges imposed by the prime broker, in addition to disclosing any commission charged by the executing broker.

12. The executing broker must keep and preserve the records required under subparagraphs (a)(6), (a)(7) and (a)(9) of Rule 17a-3<sup>31</sup> relating to trades placed with the executing broker pursuant to the prime broker arrangement.
13. If the prime broker disaffirms a trade the following steps must be taken:
  - A. the prime broker must send a cancellation notification to the customer to offset the notification sent on the day following trade date.
  - B. the executing broker must immediately send a new confirmation of the replacement transaction to the customer.

The replacement confirmation must disclose the information required under Rule 10b-10 under the Exchange Act.

14. Section 11(d)(1) prohibits an executing broker from extending or arranging for a prime broker to extend credit on a security sold by the executing broker to the customer if the executing broker was a member of a selling syndicate or group within the prior thirty days; however, the prime broker may extend credit on such a security in a margin account previously established independently by the customer if this credit was not otherwise arranged by the executing broker. Section 11(d)(1) also prohibits a prime broker from

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<sup>31</sup> 17 C.F.R. § 240.17a-3(a)(6) & (a)(7).

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extending credit on a security that it has sold or arranged for the executing broker to sell to the customer if the prime broker was a member of a selling syndicate or group for the security in the prior thirty days; however, pursuant to Rule 11d1-1(a), a prime broker may extend credit in a prime broker account on a security sold by an executing broker if the prime broker has not otherwise arranged for that sale.

15. The prime broker must treat the customer as its own customer for all purposes including Regulation T and Rules 15c3-1, 15c3-3, 17a-3 and 17a-4 under the Exchange Act, if it does not disaffirm or DK the trade as provided above. For example, if the account at the prime broker is a cash account, the prime broker is responsible for implementing the 90-day freeze under Regulation T if securities are sold before they are fully paid. If the prime broker disaffirms or DKs any trade, the executing broker must treat the customer as its own customer for each transaction which is disaffirmed or DKed.
16. Broker-dealers may not engage in prime brokerage activities with other broker-dealers or with customers if they actually know or have reason to know that such party is not in compliance with the provisions of this letter.

This is a position of the Division's staff concerning enforcement action with regard to certain aspects of Sections 7, 10, 11(d), 15(c)(3) and 17 of the Exchange Act and Regulation T thereunder, and Rules 10a-1, 10b-10, 11d1-1, 15c3-1, 15c3-3, 17a-3 and 17a-4 under the Exchange Act, and does not represent any legal conclusions. This position is based solely on the description and representations made to the Division and the FRS Division, as set forth above. Any factual variations might require a different response. This position may be withdrawn or modified if the Division determines that such action is necessary in the public interest, for the protection of investors, or otherwise, in furtherance of the purposes of the securities laws.



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The staff of the Division believes that the outlined treatment is a reasonable interim approach to the issues associated with prime brokerage. On or before December 31, 1995, the staff of the Division will notify the Prime Broker Committee with respect to extensions, modifications or termination of the no-action position expressed in this letter. During this period we will seek the assistance of the Prime Broker Committee in determining the appropriate course of action.

Sincerely,

A handwritten signature in cursive script that reads "Brandon Becker".

Brandon Becker  
Director