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CFTC Issues Advisory on Prime Brokerage Arrangements on SEFs and DCO Registration Requirements

By Peter Y. Malyshev
Partner | Financial Regulation

On May 17, the staff of Commodity Futures Trading Commission ("CFTC") Division of Clearing and Risk ("DCR") issued an advisory ("Advisory") that encourages entities using prime brokerage ("PB") arrangements that provide credit substitution on a centralized basis on swap execution facilities ("SEFs") to assess whether these activities qualify as those of a derivatives clearing organization ("DCO") and are therefore subject to registration with the CFTC. DCR notes that the Advisory was prompted by recently proposed arrangements on SEFs where a single PB would be providing credit substitution to multiple SEF participants, which, in DCR's view, would qualify these PBs as DCOs that must register.

The Advisory asserts that these PB arrangements fit within the definition of a DCO in § 1a(15)(A)(i) of the Commodity Exchange Act ("CEA"), which states that an entity, facility, system, or organization "that, with respect to an agreement, contract, or transaction ... enables each party to the agreement, contract, or transaction to substitute, through novation or otherwise, the credit of the [DCO] for the credit of the parties." The Advisory goes on to explain that DCR staff reviews all facts and circumstances and that it does not believe that all PB arrangements will qualify as DCOs.

Considering the text of the Advisory, the staff of DCR recognizes the following factors as relevant:

- the market structure is a PB arrangement;
- it is used with trading on a SEF;
- there is only one centralized PB used for multiple participants on the SEF;
- credit substitution is provided to all SEF participants;

- credit substitution is provided through "novation or otherwise"; and
- PB may or may not be a provisionally registered swap dealer ("SD").

The specific nature of these factors may limit this Advisory to specific fact patterns, distinguishing this Advisory from CFTC's advisory issued on September 29, 2021 also relating to SEFs, but with a much broader reach to commodity trading advisers and introducing brokers that, in CFTC's view, may qualify as SEFs. Future CFTC action will clarify how broadly the staff of the CFTC is prepared to interpret the Advisory. For example, in the wake of the September 29, 2021 SEF advisory, the CFTC had already settled two enforcement actions that specifically reference that advisory.

It is also likely that DCR staff will need to clarify what it considers a "credit substitution" that would be sufficient to trigger the DCO registration requirements. In a CFTC no action letter No. 19-06 issued on March 22, 2019, the CFTC also considered PB arrangements involving SDs and disclosure requirements under CFTC regulation § 23.431 and described PB arrangements where "PB performs a credit intermediation role in the transaction because the [t]rading [c]ounterparty is able to obtain a variety of prices from SEF participants but only faces its PB with respect to credit risk…" CFTC letter 19-06 did not discuss whether any PB arrangements would qualify as DCOs, and did not emphasize the relevance of the number of PBs involved (*i.e.*, if there is a single PB or multiple). Likewise, neither the CEA nor CFTC regulations note the quantity of PBs and risk substitution intermediaries as a factor in determining whether such entity is or is not a PB.

Finally, on December 5, 2022, several provisions of the CFTC's rewrite of Part 43 and 45 reporting provisions became effective where reporting counterparties for the first time need to report to swap data repositories ("SDRs") information about PB arrangements. Given the availability of reportable data coming from SDRs relating to PB arrangements, it is likely that the CFTC will further explore PB arrangements. Therefore, any SEF or entity providing PB services, either an SD or not, should conduct a thorough analysis of its operations.