DEPARTMENT OF THE TREASURY
FINANCIAL CRIMES ENFORCEMENT NETWORK

Via Facsimile to (212) 720-1655

Mark J. Snyder
Chair, Foreign Exchange Committee
Federal Reserve Bank of New York
33 Liberty Street, 9th Floor
New York, New York 10045

AUG -2 2007

Re: *Application of the Correspondent Account Rule To Executing Dealers Operating in the Over-The-Counter Foreign Exchange and Derivatives Markets Pursuant to Prime Brokerage Arrangements*

Dear Mr. Snyder:

I am writing to respond to your letter of October 23, 2006, in which the Foreign Exchange Committee requested interpretive guidance on the application of our rules implementing the correspondent account provisions of section 312 of the USA PATRIOT Act ("correspondent account rule")[1] to the over-the-counter foreign exchange and derivative markets ("OTC derivatives markets"). Specifically, you have asked us to clarify whether executing dealers conducting transactions pursuant to prime brokerage arrangements in the OTC derivatives markets have established correspondent accounts with prime brokerage clients that would require the executing dealers to comply with the correspondent account rule.

Prime brokerage arrangements in the OTC derivatives markets involve a prime broker, a prime brokerage client, and an executing dealer.[2] Prime brokerage allows

[1] See 31 C.F.R. § 103.176 (requiring covered financial institutions to establish a due diligence program "designed to enable the covered financial institution to detect and report . . . any known or suspected money laundering activity conducted through or involving any correspondent account established, maintained, administered, or managed by such covered financial institution in the United States for a foreign financial institution"), 31 C.F.R. § 103.175(f) (defining "covered financial institution" to include banks, broker-dealers, and futures commission merchants), and 31 C.F.R. § 103.175(h) (defining "foreign financial institution" to include foreign banks, foreign institutions that would be broker-dealers, futures commission merchants, and mutual funds if they were located in the United States, and foreign institutions that are readily recognizable as currency dealers or exchangers or money transmitters).

[2] Prime brokers typically are large financial institutions – such as banks, broker-dealers, and futures commission merchants – that have established credit lines for foreign exchange and derivatives trading with foreign exchange and derivatives dealers. The client often is an advisor, a manager, or a fund. An executing dealer may be, for example, a bank, a broker-dealer, a futures commission merchant, or a "currency dealer or exchanger" as that term is defined in our rules at 31 C.F.R. § 103.11(uu)(1).

clients to trade in the name of the prime broker with executing dealers approved by the prime broker.[3] When transactions are effected through a prime brokerage arrangement, the prime broker will become the counterparty to the transactions that were executed by the executing broker and the prime brokerage client, exposing the prime broker to the credit risk of the opposing parties.

A prime brokerage relationship is formed with an agreement between a prime broker and its prime brokerage client (a "prime brokerage agreement"), in which the prime broker will permit the client to trade in the prime broker's name with dealers in OTC derivatives that are approved by the prime broker. If the terms of the prime brokerage agreement are satisfied, then the prime broker will become the party to any transactions that the prime brokerage client initiates with the executing dealer. The prime brokerage agreement additionally will include an agreement by the prime brokerage client to enter into – or if the client is a manager or advisor, to have funds or accounts it manages ("client's relevant account or accounts") enter into – one or more transactions opposing the prime broker's transactions with the executing dealer. The transactions between the prime broker and its client, or the prime broker and the client's relevant accounts, if applicable, also will be governed by a master agreement between those parties.[4]

The prime broker also typically will enter into a master give-up agreement with the dealers with which its prime brokerage clients may initiate trades.[5] Pursuant to the give-up agreement, the prime broker will become the counterparty to each transaction initiated with the dealer by the prime brokerage client, subject to specified limits.[6] According to the give-up agreement, when the prime broker accepts a trade for give-up, it becomes a binding transaction between the executing dealer and the prime broker, rather than between the executing dealer and the prime brokerage client, or the client's relevant accounts, if applicable.[7] The transactions between the executing dealer and the prime

---

[3] These transactions – including, for example, spot or forward contracts, plain vanilla swaps, and structured options – typically are executed by telephone or through an electronic trading system.

[4] These agreements – such as a Master Agreement published by the International Swaps and Derivatives Association, Inc. ("ISDA Master Agreement"), an International Foreign Exchange Master Agreement ("IFEMA"), a Foreign Exchange and Options Master Agreement ("FEOMA"), or an International Currency Options Agreement ("ICOM") – will include provisions for closing out trades in the event of a default against the prime broker by the dealer, the prime brokerage client, or the client's relevant account.

[5] A prime broker and an executing dealer often will execute a Master Foreign Exchange Give-Up Agreement published by the Foreign Exchange Committee or a Master Give-Up Agreement published by ISDA.

[6] These limits generally will parallel the limits contained in the prime brokerage agreements that the prime broker will execute with its prime brokerage clients.

[7] This transaction between the dealer and the prime broker is opposed by transaction between the prime broker and the client, or the client's account when applicable.

broker typically will be governed by the terms of the same master agreement that governs the direct trading between those two institutions,[8] subjecting the executing dealer to the credit risk of the prime broker rather than the prime brokerage client.

The correspondent account rule applies to correspondent accounts that are established, maintained, administered, or managed by a covered financial institution for a foreign financial institution.[9] An account is defined for the purposes of the correspondent account rule to include only "formal relationships."[10] We do not view the interaction between an executing dealer and a prime brokerage client as the establishment, maintenance, administration, or management of a correspondent account for the prime brokerage client.[11]

The interaction between an executing dealer and a prime brokerage client typically is limited to the initiation of an OTC derivatives transaction by telephone or electronic trading system on a trade-by-trade basis.[12] Moreover, the executing dealer and the prime brokerage client do not effect transactions with each other. Rather, each party will effect a transaction with the prime broker, who contemporaneously will enter into opposing transactions with the executing dealer pursuant to the master give-up agreement on the one hand, and the prime brokerage client, funds managed by the client, or a bank that holds accounts for the client pursuant to the prime brokerage agreement with the client on the other hand. In such circumstances, an executing dealer does not establish, maintain, administer, or manage a correspondent account with a prime brokerage client

---

[8] See supra note 4. In many cases the prime broker and the executing dealer will have entered into a master agreement that governs the transactions between these parties -- These agreements – such as a Master Agreement published by the International Swaps and Derivatives Association, Inc. ("ISDA Master Agreement"), an International Foreign Exchange Master Agreement ("IFEMA"), a Foreign Exchange and Options Master Agreement ("FEOMA"), or an International Currency Options Agreement ("ICOM") – will include provisions for closing out trades in the event of a default against the prime broker by the dealer, the prime brokerage client, or the client's relevant account.

[9] See 31 C.F.R. § 103.175(d)(1)(i) (defining the term "correspondent account" as an account that is established "to receive deposits from, or to make payments or other disbursements on behalf of, the foreign financial institution, or to handle other financial transactions related to [the] foreign financial institution").

[10] See 31 C.F.R. § 103.175(d)(2)(i)-(iii) (defining the term "account," respectively, for banks, broker-dealers in securities, and futures commission merchants).

[11] See, e.g., Application of the Regulations Requiring Special Due Diligence Programs for Certain Foreign Accounts to Certain Introduced Accounts and Give-Up Arrangements in the Futures Industries, FIN-2006-G011 at 4-5 (June 7, 2006) (futures commission merchants operating solely as executing brokers in give-up arrangements are not required to comply with the due diligence provisions of the correspondent account rule).

[12] An executing dealer and a prime brokerage client may enter into a compensation or reimbursement agreement, under which the executing dealer may be compensated if a prime broker does not accept a trade for give-up that was conducted by the prime brokerage client. The existence of a compensation or reimbursement agreement would not alter our conclusions, as the agreement is not established to handle financial transactions. See supra note 9 (definition of "correspondent account").

that would require an executing dealer to comply with the due diligence provisions of the correspondent account rule.[13]

We caution, however, that this interpretation should not be construed as limiting the anti-money laundering obligations of executing dealers under our rules. Each financial institution subject to an anti-money laundering program rule should establish and implement risk-based policies, procedures, and controls for assessing the money laundering risk posed by its operations, including the execution of over-the-counter foreign exchange and derivatives transactions; for monitoring and mitigating that risk; and for detecting and reporting suspicious activity.

In arriving at our conclusions in this interpretive guidance, we have relied upon the accuracy and completeness of the representations in your letter. Nothing precludes us from reaching different conclusions or from taking further action if circumstances change or if any of your representations are inaccurate or incomplete. We reserve the right to publish this letter as guidance. Please inform us within fourteen (14) days from the date of this letter of any information that you believe should be redacted from this letter and the legal basis for redaction.

We appreciate the opportunity to clarify the issues that you raised. If you have further questions about this guidance, please contact Beverly Loew, Regulatory Policy Project Officer, at (202) 354-6409.

Sincerely,

Koko Ives for Susan Lang

Susan D. Lang
Assistant Director
Office of Regulatory Policy

cc: Richard Charlton, Federal Reserve Bank of New York
Robert Spielman, Deutsche Bank

---

[13]This guidance addresses whether correspondent accounts exist between executing dealers and prime brokerage clients. We are not addressing whether a correspondent account exists between a prime broker and an executing dealer, a prime broker and a prime brokerage client, or a prime broker and the client's relevant account.