

DERIVATIVES LAWS & REGULATIONS FOR ALTERNATIVE ASSET MANAGERS

DERIVATIVES MARKET ARCHITECTURE: SWAPS, REPOS, AND PRIME BROKERAGE FRAMEWORKS FOR ALTERNATIVE ASSET MANAGERS



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Overview of the Derivatives Market

Derivatives, by their essential definition, are financial instruments whose value is derived from an underlying reference asset, index, rate, or other measurable variable. These instruments serve a multiplicity of functions, from facilitating bespoke hedging strategies to offering directional exposure, risk mitigation protocols, and liquidity access frameworks. They are utilized across nearly every asset class and by nearly every institutional participant, from hedge funds and pension plans to insurance companies, sovereigns, and global financial institutions.

At its core, the derivatives ecosystem encompasses a suite of products that includes swaps, options, forwards, futures, repurchase and reverse repurchase agreements, and securities lending arrangements. Each instrument carries its own structural features, risk profile, and documentation architecture.

Swaps, in particular, occupy a central position in the over-the-counter (OTC) derivatives landscape. These bespoke contracts are typically governed by an industry-standard legal framework developed by the International Swaps and Derivatives Association (ISDA), which includes the ISDA Master Agreement and the accompanying Credit Support Annex (CSA). Together, these documents structure the legal and credit risk relationship between counterparties and are highly customized through a Schedule and various bespoke amendments.

The ISDA Master Agreement serves as the backbone of OTC derivatives trading, setting out the terms that apply to all transactions between the parties. Individual trades are captured through Confirmations that reflect the economic details negotiated between the counterparties. The framework provides mechanisms for addressing Events of Default—such as failures to pay or deliver, misrepresentations, insolvency, and breaches of other financial agreements—which trigger the Non-defaulting Party's right to terminate the entire trading relationship and close out all transactions. The ISDA also delineates Termination Events, which, while distinct from defaults, allow a Non-Affected Party to terminate impacted trades in response to events such as changes in law, tax events, and credit-related corporate actions. Market participants often negotiate additional Termination Events, reflecting internal counterparty risk assessments and operational triggers, such as a fund's net asset value declining beyond a set threshold, the resignation of a key investment professional, or an unapproved change to investment strategy.

In the event of default or termination, counterparties utilize Close-out Netting to determine a single net payment owed between parties, reducing exposure and potential systemic risk. This process is administered by the Calculation Agent, a party typically designated as the dealer counterparty, who also manages day-to-day pricing and collateral workflows. The Calculation Agent generally has certain minimum standards of care contractually imposed under the ISDA agreement and related ISDA definitions. The non-dealer counterparty often retains the right to dispute determinations by the Calculation Agent, providing a safeguard against unilateral valuation decisions.

The Credit Support Annex operationalizes the collateralization of exposure under the ISDA Master Agreement. It establishes the parameters for initial margin, variation margin, eligible collateral types, and thresholds for collateral transfers. These provisions have become increasingly complex in response to regulatory mandates arising from the 2008 financial crisis and the subsequent passage of the Dodd-Frank Act, which sought to bring transparency, structure, and systemic protections to the historically opaque OTC derivatives market.

Dodd-Frank introduced a two-tiered regulatory framework: the Commodity Futures Trading Commission (CFTC) exercises jurisdiction over most swaps, while the Securities and Exchange Commission (SEC) oversees security-based swaps. The law requires dealers exceeding certain notional thresholds to register as Swap Dealers or Security-Based Swap Dealers and imposes robust reporting, recordkeeping, margining, and business conduct standards. While many compliance obligations fall on the dealer, buy-side entities must provide identifying information, operational transparency, and collateral compliance. Notably, variation and initial margin requirements are tiered based on notional exposures and the nature of the transaction party, a structure designed to ensure proportionate risk management across the market. Specifically, Independent Amounts and Variation Margin have, as related Dodd-Frank regulations have come online, become mandatory based on the parties and transaction, and ISDA has produced accommodating IA/VM Credit Support Annex documentation which is becoming increasingly used.

Cross-border considerations further complicate the regulatory analysis. While the U.S. regime is extraterritorial in nature, foreign counterparties may be eligible for substituted compliance based on home jurisdiction regulatory parity. Multinational market participants must thus navigate a complex lattice of cross-jurisdictional rules and bilateral arrangements.

The implementation and evolution of clearing mandates has also reshaped the swap market, particularly for standardized interest rate swaps, credit default swaps, and certain foreign exchange derivatives, regulated by relevant CFTC rules, as well as for any security-based swaps that become subject to future mandatory clearing determinations by the SEC (under Section 3C of the Exchange Act). Cleared swaps introduce central counterparties into the transactional chain, thereby reducing bilateral counterparty risk but introducing operational and legal challenges surrounding initial margin segregation, porting of positions, and default waterfall structures.

Running parallel to the OTC derivatives market are repurchase and reverse repurchase agreements, which allow market participants to, in effect, borrow assets to facilitate trading activity, monetize current assets and also to manage access to the critical treasury markets. In a fashion similar to past swaps clearing regulations implementation, recent Dodd Frank regulations have implemented a requirement for the majority of U.S. Treasury market transactions to be cleared through an SEC-approved Covered Clearing Agency (CCA). While the requirement for cash market transactions only covers trades by certain larger banking institutions and has a compliance date of December 31, 2026, repurchase transactions referencing a treasury security will be required to be mandatorily cleared by all market participants by June 30, 2027.

Another critical element to most buy-side market participant trading strategies are the utilization of prime brokerage and custody arrangements, which facilitate financing, trading, and custody services for hedge funds and other institutional investors. Prime brokerage agreements are similarly characterized by detailed default regimes, broadly drafted netting and rehypothecation rights, and collateral movement mechanics. Prime brokers rely heavily on sub-custodians and agents to operationalize client mandates, and clients are typically subject to stringent margin delivery obligations, coupled with indemnification provisions that significantly limit the broker's liability exposure.

Regulatory capital, margin, and operational leverage requirements under Regulation T and portfolio margining regimes further define the scope of a prime brokerage relationship. U.S.-regulated prime brokers must comply with the minimum net equity standards imposed by the SEC's 1994 No-Action Letter, and client assets are protected within the contours of the Securities Investor Protection Act (SIPA), which provides a limited insurance framework in the event of broker-dealer insolvency. Developments in prime brokerage often reflect broader market dynamics, including the increasing prevalence of lock-up agreements that bind clients to longer-term relationships in exchange for more favorable pricing and liquidity access.

In sum, the derivatives and financing ecosystem is governed by a sophisticated overlay of legal frameworks, documentation standards, and regulatory regimes. Each counterparty interaction—from the negotiation of an ISDA Schedule to the movement of collateral under a CSA or the default of a prime broker—requires close scrutiny from legal counsel well-versed in the contours of credit risk, contract enforceability, regulatory compliance, and market practice. The following chapters will delve deeper into these structures, offering practical insights and highlighting emerging trends that continue to shape the institutional derivatives market.

Swaps

Transactional Issues and documentation

Swaps are among the most structurally flexible and widely used instruments in the over-the-counter (OTC) derivatives market. They serve as the bedrock for risk management strategies across interest rates, currencies, commodities, credit, and equity instruments. At their core, swaps permit counterparties to gain synthetic exposure to asset classes, exchange cash flows or manage economic, credit or other various risks under customized terms negotiated directly between the parties. Because many swaps do not trade on centralized exchanges (unless they are regulatorily required to be cleared or the parties make an election to clear), their contractual underpinnings are critically important, and much of the legal architecture surrounding OTC swap transactions derives from the framework established by the International Swaps and Derivatives Association, Inc. (ISDA).

Swaps and OTC options are almost universally documented under the ISDA Master Agreement, a standardized contract that governs the legal and credit relationship between the parties across multiple transactions. The ISDA Master Agreement is intended to be executed once and applies across all transactions entered into by the parties under that relationship. It is typically accompanied by a Schedule, which tailors the terms of the Master to the specific risk tolerances, operational requirements, and credit considerations of the counterparties. The parties may (and buy-side market participants usually do) also enter into a Credit Support Annex (CSA), which sets forth collateralization mechanics and credit support terms. Each individual swap is further documented by a Confirmation that reflects the negotiated economic terms. Together, this suite of documents forms a legal and operational infrastructure intended to promote consistency, mitigate credit exposure, and facilitate close-out mechanisms in distressed scenarios.

One of the most essential components of the ISDA Master Agreement is the framework governing Events of Default. These provisions define the universe of breaches or failures that can trigger the right of one party (the Non-defaulting Party) to terminate all transactions and determine a single net settlement amount. Events of Default include non-payment or non-delivery, breaches of representations or covenants, cross-defaults to other indebtedness, bankruptcy, and the failure of credit support arrangements, among others. Of particular note, ISDA also contains a “Cross Default” provision, under which a default under a separate agreement or transaction with the same counterparty or a related third party may trigger default under the ISDA. In practice, the inclusion or exclusion of Cross Default provisions—and the scope of their application—are highly negotiated items, particularly in buy-side engagements where institutional investors may seek to ringfence trading exposures to a single legal entity or strategy.

Distinct from Events of Default are Termination Events, which entitle the Non-Affected Party to terminate only the impacted transactions, leaving the broader trading relationship intact. These events often arise from changes in law or regulation (illegality), tax consequences, or certain credit events occurring upon merger or corporate restructuring. Notably, the ISDA framework also accommodates the addition of bespoke “Additional Termination Events,” which are regularly negotiated in response to a dealer’s internal credit assessment of its counterparty. These may include triggers tied to net asset value declines, the departure of key investment personnel, changes to fund documentation or investment strategy, and failure to deliver specified documents. The strategic use of such events functions as a risk management tool, providing an off-ramp should the counterparty’s financial profile or operational integrity change materially.

When a termination right—whether resulting from default or a termination event—is exercised, the ISDA permits the Non-defaulting or Non-Affected Party to value all open transactions and determine a net close-out amount. This process, known as Close-out Netting, allows the party to offset positive and negative replacement values across all terminated trades and to apply posted collateral in satisfaction of the net exposure. The result is the crystallization of exposure into a single obligation, minimizing unsecured claims and reducing systemic contagion risk. In the absence of default, the parties may also agree to Transactional Netting provisions, whereby the Calculation Agent determines net cash flows payable under active transactions on a daily or periodic basis, minimizing gross settlement obligations and streamlining collateral movement.

The ISDA framework also addresses a range of deliverable obligations between the parties, including the provision of tax documentation, account statements, NAV reports, and legal opinions. These ancillary obligations are particularly important in managed fund relationships, where operational transparency and regulatory compliance depend on timely delivery of information from the investment manager or administrator.

The Calculation Agent, typically the dealer or bank counterparty, plays a central role in valuing trades, determining collateral calls, and administering cash flows. While the agent is generally vested with broad discretion, the non-dealer counterparty is sometimes afforded a limited set of dispute rights, including the right to challenge valuations through reference to third-party quotations or independent valuations. These rights serve as a procedural safeguard, preventing the unilateral imposition of economically adverse valuations by the party with greater informational asymmetry.

Collateralization under a swap relationship is governed by the Credit Support Annex, which has evolved into a core element of risk mitigation and regulatory compliance. The CSA defines the parameters for initial margin (posted at trade inception), variation margin (posted daily or periodically in response to mark-to-market changes), eligibility criteria for collateral, thresholds, independent amounts, and haircuts. In the United States, the New York law CSA is the prevailing form, though an English law variant is often used for cross-border relationships. The CSA permits parties to structure collateral support arrangements that reflect their relative credit strength and operational preferences. Importantly, collateral mechanics are often integrated with the parties' internal risk systems and valuation engines, requiring legal teams to liaise closely with operational personnel to ensure alignment between contractual terms and collateral workflows. [Add a few sentences discussing the impact of the CFTC and SEC margin rules on CSA margining (including initial margin and variation margin), focused primarily on the impact on non-bank counterparties (i.e., hedge funds), referring to the "Swaps Regulatory Framework" section below for additional detail]

Beyond these structural elements, the ISDA Master Agreement includes numerous bilateral elections and ancillary provisions that shape the broader trading relationship. These include set-off rights, representations and warranties, tax indemnities, and documentation delivery obligations. Together, they reflect the cumulative experience of market participants and counsel in codifying best practices, legal protections, and operational clarity in a complex and evolving transactional landscape.

Finally, the post-crisis regulatory environment has given rise to a parallel category of “cleared swaps,” which are subject to mandatory central clearing under rules adopted by the Commodity Futures Trading Commission (CFTC) and other global regulators. Cleared swaps introduce a central counterparty (CCP) into the transaction chain, replacing bilateral credit risk with standardized margining, default management procedures, and segregation requirements. [Discuss how swap clearing arrangements are generally documented pursuant to a futures clearing/FCM agreement with an FCM and related OTC clearing addendum, the latter of which is often based on the FIA-ISDA Cleared Derivatives Addendum form] [Discuss benefits to the market, as well as risks and benefits to market participants, in giving up trades to a CCP in contrast to bilateral transactions] While clearing has increased transparency and mitigated counterparty credit concerns in certain markets—particularly interest rate and credit default swaps—it also imposes higher collateral requirements, increased operational burden, and less flexibility in structuring trade terms. [Discuss SEC mandatory clearing - security-based swaps that become subject to future mandatory clearing determinations by the SEC (under Section 3C of the Exchange Act)]

In sum, the transactional documentation and operational considerations surrounding swaps demand a sophisticated understanding of legal principles, regulatory regimes, and market practice. Counsel must not only negotiate the ISDA framework with precision but also advise clients on the broader implications of their derivative activities—including risk management, credit exposure, documentation consistency, and evolving market norms. In the next chapter, we turn to the statutory and regulatory architecture that governs swaps and swap dealers under the Dodd-Frank Act and related rules, and the impact of those regulations on transaction structuring, documentation, and compliance obligations.

Swaps Regulatory Framework

The regulatory framework governing swap transactions has undergone a profound transformation since the global financial crisis of 2008. In response to systemic risk concerns and opacity in the derivatives markets, lawmakers in the United States enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), which created a comprehensive regime for the oversight of swap and security-based swap markets. These statutory and regulatory provisions have fundamentally reshaped how derivatives are structured, documented, executed, and monitored, placing new obligations on both dealers and buy-side participants. Understanding this framework is essential not only for legal compliance but also for strategic transaction planning and risk management.

Under Dodd-Frank, regulatory authority over swaps is bifurcated. The Commodity Futures Trading Commission (CFTC) has primary jurisdiction over most categories of swaps, including interest rate swaps, foreign exchange swaps, commodity swaps, and certain types of credit default swaps. Security-based swaps—those based on a single security, a loan, or a narrow-based index of securities—fall within the regulatory purview of the Securities and Exchange Commission (SEC). This division necessitates careful classification of the underlying economic exposure in each transaction to ensure proper regulatory treatment. Moreover, swap transactions involving prudentially regulated entities (such as bank holding companies or insured depository institutions) may be subject to additional oversight by Prudential Regulators, including the Federal Reserve Board and the Office of the Comptroller of the Currency (OCC), particularly with respect to capital and margin requirements.

Market participants engaged in swap dealing activity must consider whether their activities trigger mandatory registration as a Swap Dealer or Security-Based Swap Dealer. Registration is generally required for any entity whose swap-related activities exceed the applicable de minimis threshold, currently set at \$8 billion in aggregate gross notional amount of swap dealing activity (subject to exceptions). Once registered, dealers are subject to a range of obligations, including risk management policies, capital requirements, business conduct standards, and periodic reporting. The dealer registration regime is intended to enhance oversight of entities that serve as key liquidity providers in the derivatives market, and registration itself imposes a permanent and ongoing compliance infrastructure on registered entities.

A central tenet of the post-Dodd-Frank regime is transparency. Registered Swap Dealers and Security-Based Swap Dealers are required to report detailed information about their transactions to swap data repositories (SDRs), facilitating market oversight by regulators and public transparency of pricing and volume data. While these reporting obligations primarily fall on dealers, buy-side entities are not wholly insulated from their effect. Counterparties are typically required to provide Legal Entity Identifiers (LEIs), ensure that the dealer has sufficient information to meet its reporting obligations, and may, in some cases, be required to report directly where both parties are non-dealers. In cross-border contexts, reporting obligations may become even more complex, as local reporting regimes in non-U.S. jurisdictions may apply, and parties must navigate potentially overlapping disclosure obligations.

Another cornerstone of the Dodd-Frank framework is the requirement to exchange collateral on uncleared swaps. The margin rules, jointly promulgated by the CFTC, SEC, and Prudential Regulators, require the exchange of both initial margin and variation margin between covered entities based on the type of counterparty and the notional size of their portfolios. Initial margin is intended to cover potential future exposure in the event of a counterparty default, while variation margin reflects current mark-to-market exposures. These margining requirements are phased in based on the aggregate notional amount of swaps and security-based swaps entered into by the counterparties and their affiliates. Parties subject to the margin rules must have in place legally enforceable collateral documentation—typically via the ISDA Credit Support Annex and related margin documentation—along with operational capabilities to manage margin calls, eligible collateral, and collateral segregation. Legal counsel plays a critical role in advising on the enforceability of netting and collateral arrangements, especially across jurisdictions.

Cross-border derivatives activity adds further complexity to the regulatory analysis. Although Dodd-Frank was enacted with a primarily domestic focus—aimed at protecting U.S. markets and market participants—it has extraterritorial reach in certain circumstances. Foreign entities that engage in swap transactions with U.S. counterparties, or that are guaranteed by U.S. entities, may find themselves subject to U.S. regulatory requirements. That said, the CFTC, Prudential Regulators SEC have recognized the potential for regulatory overlap and have created exemptions and substituted compliance regimes to mitigate duplicative regulation. Under substituted compliance, non-U.S. dealers may rely on the regulatory framework of their home jurisdiction, provided that it is deemed comparable to U.S. rules. Legal analysis is required to determine eligibility for such exemptions, and parties must be prepared to support their compliance position through representations and documentation.

The regulatory framework also implicates broader transactional considerations. Parties must take care to structure their swap relationships in a manner that satisfies regulatory requirements without introducing operational friction or legal uncertainty. This includes determining whether a particular counterparty relationship may cause a firm to cross the dealer registration threshold, whether margin obligations will apply, how swap reporting will be allocated, and whether U.S. or foreign law governs the enforceability of netting and collateral provisions. Each of these determinations has downstream implications for legal documentation, operational infrastructure, and risk allocation.

In practice, market participants have adapted to the Dodd-Frank regime through the use of standardized protocols and industry documentation developed by ISDA, including the Dodd-Frank Reporting Protocol, the EMIR/DF Protocol for cross-border trades, and various bilateral supplements addressing regulatory compliance. Nevertheless, bespoke negotiation remains essential in many cases—particularly for funds and institutions seeking to preserve operational flexibility, minimize compliance burdens, and maintain alignment with internal risk management frameworks.

As the regulatory landscape continues to evolve, swap market participants must remain vigilant in monitoring developments at the CFTC, SEC, and global counterparts. Rulemaking efforts relating to digital assets, ESG-related financial products, and algorithmic trading may further expand the scope and complexity of swap regulation in the coming years. Legal counsel must therefore serve not only as document drafters, but as strategic advisors and interpreters of evolving regulatory expectations in a market that is as dynamic as it is essential to global finance.

Developments and Market Trends

The derivatives landscape—particularly in the context of swaps—continues to evolve in response to shifting regulatory priorities, macroeconomic volatility, technological innovation, and institutional trading behaviors. For market participants and their counsel, staying attuned to emerging trends is not merely a matter of academic interest, but a strategic imperative. The legal architecture governing swaps must be responsive to these developments, both in terms of risk mitigation and operational execution. In this chapter, we examine several key areas of change that are shaping the present and future of the swaps market.

One of the most significant market developments in recent years has been the global transition away from interbank offered rates (IBORs), most notably LIBOR, and toward alternative risk-free reference rates (RFRs). Following years of regulatory warnings and industry guidance, the use of LIBOR in new swap transactions has largely ceased, with fallback provisions and protocol-based amendments governing the treatment of legacy trades. In the U.S., the Secured Overnight Financing Rate (SOFR) has become the prevailing replacement benchmark for USD-denominated swaps. This shift has introduced new basis risks, documentation challenges, and valuation complexities—particularly in legacy portfolios where terms had not been robustly addressed in the original confirmations or Schedules. Legal counsel has been instrumental in managing this transition, including through adherence to the ISDA IBOR Fallbacks Protocol and bilateral negotiation of tailored fallback language, as well as advising on valuation and settlement adjustments required by benchmark transitions.

Technology and automation are also driving change across the swaps market. The deployment of smart contracts and distributed ledger technology (DLT) in derivatives remains in its early stages but holds the potential to significantly streamline trade execution, valuation, and collateral workflows. Institutions and fintech developers are actively exploring programmable swap structures, whereby performance obligations are automatically calculated and triggered via code-based protocols. Legal and regulatory questions surrounding enforceability, jurisdiction, and dispute resolution mechanisms remain largely unsettled, but industry initiatives—such as ISDA’s Common Domain Model (CDM)—aim to establish standardized data and process definitions that will support greater automation and interoperability across platforms. Attorneys must anticipate these shifts and consider the legal implications of replacing traditional human-based determinations (e.g., calculation agent discretion) with algorithmic processes.

On the regulatory front, enforcement and compliance expectations continue to expand. Regulators in the U.S. and abroad have intensified their scrutiny of swap trading practices, particularly with respect to trade reporting, margin compliance, and market conduct. Enforcement actions by the CFTC and SEC have increasingly targeted failures to supervise, gaps in swap data reporting, and violations of business conduct standards. Simultaneously, global regulators are harmonizing margin and clearing mandates, increasing pressure on non-U.S. entities to maintain equivalency with Dodd-Frank and EMIR standards. The result is a more rigorous compliance environment that demands continuous monitoring, internal audits, and operational controls—areas where legal counsel must play a proactive, integrative role.

Clearing mandates continue to expand as well. Interest rate swaps denominated in major currencies, certain FX derivatives, and index credit default swaps are now routinely cleared through central counterparties (CCPs), with additional products expected to follow. Clearing reduces bilateral credit risk and facilitates multilateral netting, but also imposes structural constraints on customization and collateral flexibility. From a legal documentation perspective, cleared swaps introduce new contracts—clearing agreements, FCM agreements, and account control agreements—which must be negotiated alongside traditional ISDA documentation. Furthermore, default management processes under clearing arrangements differ markedly from bilateral close-out regimes and require a parallel understanding of CCP rules and membership structures.

Buy-side institutions have also become more sophisticated in how they approach swap documentation and counterparty relationships. Negotiation of bespoke Additional Termination Events, tiered collateral thresholds, NAV triggers, and liquidity covenants have become standard fare for institutional asset managers. Fund-level governance documents, investor disclosures, and risk policies are increasingly linked to swap documentation, creating a web of contractual and fiduciary obligations that must be navigated with precision. At the same time, end-users are leveraging ISDA protocols and standardizations to streamline onboarding and reduce negotiation friction across multiple counterparties.

In sum, the swaps market is in a period of dynamic transformation. Whether in response to benchmark reform, regulatory realignment, or technological evolution, the legal framework supporting swap transactions must evolve in tandem. Practitioners must not only interpret current rules but anticipate new developments, ensuring that legal structures remain adaptive, enforceable, and aligned with institutional objectives. The chapters that follow will further explore these implications across other product sets and legal relationships that intersect with the swap markets, including prime brokerage, custody, and financing structures.

Repurchase and Reverse Repurchase Agreements

Repurchase agreements, or “repos,” and their counterpart, reverse repurchase agreements, are essential instruments in modern financial markets. These transactions allow participants to obtain short-term financing, monetize securities holdings, and manage liquidity exposure while maintaining access to critical treasury markets. In a typical repo, one party sells securities to another with an agreement to repurchase them at a specified later date and price. From an economic standpoint, this functions much like a secured loan, with the securities acting as collateral. The reverse repo represents the other side of the transaction, where the buyer of the securities agrees to sell them back at a future date.

These transactions are most commonly documented under standard form agreements such as the Master Repurchase Agreement (MRA) or the Global Master Repurchase Agreement (GMRA), published by SIFMA and ICMA respectively. These master agreements are adapted to the specific needs of counterparties and transaction types through a series of annexes and transaction confirmations. Each individual transaction conducted under the agreement specifies the purchase price, the securities involved, and the repurchase date. On the purchase date, the seller delivers the securities in exchange for cash; on the repurchase date, the seller returns the cash with interest and receives back the securities. Precision in payment and delivery is critical, especially when transactions are cleared or settled through tri-party agents or clearing platforms.

From a legal standpoint, the treatment of collateral in a repo is based on a title transfer model. Legal ownership of the securities passes to the buyer during the term of the repo. This creates a range of legal and regulatory implications, including the right of the buyer to reuse (rehypothecate) the collateral, the treatment of the transaction in insolvency scenarios, and the classification of the exposure for capital purposes. Most agreements also include margining provisions to protect against collateral value fluctuations. These provisions require the delivery of additional securities or cash when the market value of the underlying collateral changes significantly, helping to maintain the transaction’s credit risk profile.

Repos also contain comprehensive provisions dealing with defaults and post-default close-out procedures. Events of default typically include failures to pay or deliver, insolvency events, and misrepresentations. If a default occurs, the non-defaulting party may terminate all outstanding transactions under the master agreement and determine a single close-out amount. These calculations often rely on valuations conducted at the time of termination, with the inclusion of applicable haircuts or discounts. Given the volatility of collateral values—especially during stressed market conditions—accurate and timely valuation is paramount to mitigate potential losses and disputes.

On the regulatory front, the Securities and Exchange Commission has introduced significant new rules designed to enhance stability and transparency in the U.S. Treasury market. These rules mandate that certain transactions involving U.S. Treasury securities, including repo and reverse repo transactions, must be centrally cleared through an SEC-registered Covered Clearing Agency (CCA). The implementation of this mandate follows a staggered timeline. For cash market Treasury transactions, the clearing requirement applies only to larger banking institutions and will take effect on December 31, 2026. However, the timeline for repo transactions is more aggressive. As of June 30, 2027, all repo and reverse repo transactions referencing U.S. Treasuries—regardless of the size or classification of the market participant—must be cleared through a CCA.

This regulatory development mirrors the approach taken in the wake of the global financial crisis with respect to the central clearing of over-the-counter derivatives. Like those earlier reforms, the Treasury repo clearing mandate is intended to reduce systemic risk, promote market transparency, and standardize post-trade processes. That said, its impact will be significant. Market participants, including broker-dealers, asset managers, and custodians, will need to adapt their operational, legal, and risk management frameworks to ensure compliance with the clearing requirement and maintain access to a critical segment of the U.S. funding markets.

Regulatory Framework and New Developments

In a fashion similar to past swaps clearing regulations implementation, recent Dodd Frank regulations have implemented a requirement for the majority of U.S. Treasury market transactions to be cleared through an SEC-approved Covered Clearing Agency (CCA). While the requirement for cash market transactions only covers trades by certain larger banking institutions and comes only in December 31, 2026, repurchase transactions referencing a treasury security will be required to be mandatorily cleared by all market participants by June 30, 2027.]

Prime Brokerage and Custody Agreements

Transactional Issues

Prime brokerage agreements are foundational legal instruments for institutional market participants seeking to access leverage, custody, and execution services through a consolidated counterparty relationship. These agreements are not merely operational frameworks; they are complex legal contracts that allocate credit risk, delineate performance obligations, and provide for extensive rights of collateral movement, rehypothecation, and termination. For hedge funds, private funds, family offices, and other buy-side entities, the negotiation of the prime brokerage agreement is a critical exercise in risk control, asset segregation, and operational continuity. This chapter examines the principal transactional features of prime brokerage and custody agreements through the lens of institutional practice.

At their core, prime brokerage agreements establish the legal and economic scope of the relationship between a buy-side client and its prime broker. The scope of services may include trade execution, margin lending, custody of securities and cash, short sale facilitation, securities lending, and reporting services. Critically, the prime brokerage agreement often incorporates or references a suite of related documents—customer account agreements, margin addenda, securities lending agreements, and control agreements—each of which must be read in concert to assess the full risk and operational profile of the relationship. The scope provision also often identifies which legal entity within a larger broker-dealer group is the counterparty, a determination that carries significant implications for regulatory oversight, insolvency treatment, and legal enforceability.

Events of default under a prime brokerage agreement tend to be broadly drafted and are often more expansive than those found in other bilateral financing agreements. In addition to standard defaults such as failure to make payments or deliveries, the prime broker may declare a default upon a general breach of agreement terms, insolvency events, material misrepresentations, cross-defaults to other indebtedness, regulatory disqualification of the customer, or the attachment or seizure of the customer's assets. Prime brokers frequently include bespoke events of default tailored to their internal risk management protocols—for example, failure to maintain a minimum NAV, violations of investment guidelines, or withdrawals by significant investors. These provisions are drafted with a view to maximizing the broker's discretion in managing its exposure to fund clients and may permit the broker to liquidate positions, recall borrowed securities, or accelerate outstanding obligations upon the occurrence of an event of default, regardless of whether the fund is otherwise solvent or performing.

Netting rights in prime brokerage documentation are among the most operationally and legally significant provisions. Prime brokers typically include sweeping contractual set-off and netting language that permits them to consolidate obligations across multiple accounts, asset classes, and trading strategies. These provisions may allow the broker to net amounts owed by the client under margin loans, securities lending, and repo transactions, and to use assets held in custody or margin accounts to satisfy those obligations. For the client, this presents a concentration risk, as the broker may have significant discretion in reallocating assets to cover obligations across a broad transactional universe. Legal counsel representing the buy-side must closely review and, where appropriate, negotiate limitations on these rights—particularly where the client’s strategies involve ring-fenced assets or leverage across multiple jurisdictions or legal entities.

Another key feature of the prime brokerage model is the use of sub-custodians and agents. Prime brokers do not typically maintain all client assets on their own books, but rather appoint affiliated or third-party custodians to hold securities, cash, and other collateral. These sub-custodians may be located in multiple jurisdictions and subject to varying levels of regulatory oversight and insolvency protections. The agreement will typically disclaim the prime broker’s liability for acts or omissions of such sub-custodians, and will often vest the prime broker with wide latitude to appoint or replace them without client consent. This arrangement introduces custodial risk and may raise concerns over asset segregation, insolvency priority, and operational transparency. Clients with complex regulatory or tax profiles—such as ERISA plans or funds operating in foreign markets—must assess these risks carefully and may require side letters or bespoke terms to address specific concerns.

The margin delivery mechanics under a prime brokerage agreement are central to the broker-client relationship. The agreement will specify the timing, form, and method of margin calls, as well as the types of eligible collateral and the applicable haircuts. Typically, a customer is required to meet margin calls within a short window—often same-day or T+1—following demand. Failure to meet a margin call may itself constitute an event of default or permit the broker to liquidate positions without further notice. Prime brokers maintain internal risk models that may result in discretionary margin calls, even in the absence of market movements, and reserve broad rights to increase margin requirements unilaterally based on changes in market conditions, client exposures, or volatility metrics. Counsel advising clients must ensure that the agreement provides reasonable transparency and safeguards with respect to discretionary margin changes and should seek to clarify the consequences of delayed collateral delivery, including grace periods and cure rights.

Liability and indemnity provisions in prime brokerage documentation are often heavily negotiated. Prime brokers typically seek to limit their liability to losses arising solely from gross negligence, willful misconduct, or fraud, and even then may attempt to cap damages or exclude liability for consequential losses. Conversely, clients are typically required to provide broad indemnities in favor of the broker, covering losses, costs, and expenses arising from the client's trading activity, instructions, and use of services. These indemnities often extend to affiliates, agents, and sub-custodians of the prime broker and may survive termination of the agreement. From the client's perspective, it is essential to calibrate these provisions to reflect the respective roles and responsibilities of the parties, and to ensure that indemnity and liability terms are not unduly one-sided, particularly in light of the broker's discretion to act unilaterally under many operational clauses.

In total, the prime brokerage agreement is a highly negotiated instrument that blends contractual risk allocation, operational mechanics, and regulatory compliance. Each clause—from default provisions to netting rights to margin timing—has significant implications for a fund's liquidity, trading flexibility, and legal protections. Counsel representing either side must possess not only a mastery of the document's legal structure but also a keen understanding of the client's operational model, investment strategy, and risk tolerance. In the next chapter, we will explore the regulatory framework applicable to prime brokerage arrangements, including margin regulation, rehypothecation limits, and investor protections under U.S. securities law.

Regulatory Framework

Prime brokerage relationships exist at the intersection of market liquidity, custodial services, and margin financing, and as such, they are subject to a complex and layered regulatory environment. While the prime brokerage agreement is a privately negotiated contract, the services it governs are constrained by a framework of statutory rules, regulatory guidance, and longstanding no-action positions issued by the Securities and Exchange Commission (SEC) and other financial regulators. For both dealers and institutional clients, understanding the regulatory perimeter is essential to maintaining legal compliance, ensuring operational flexibility, and managing systemic and counterparty risk.

At the federal level, one of the principal regulatory constraints on prime brokerage margin lending arises under Regulation T of the Federal Reserve Board. Regulation T governs the extension of credit by broker-dealers for the purpose of purchasing or carrying margin securities. Under this rule, the default margin requirement for equity securities is 50% of the purchase price—meaning that a broker-dealer may finance up to 50% of the transaction, with the customer required to fund the remaining half from its own capital. This standard applies to U.S.-regulated margin accounts and sets a baseline that primes the capital structure for most traditional cash equity trading activity. Regulation T is not a limit on leverage per se, but a constraint on the type and amount of credit that may be extended by a U.S. broker-dealer, making its interpretation and application central to prime brokerage structuring.

However, market practice has developed a number of lawful pathways to exceed the margin limitations of Regulation T. One such method is through the use of enhanced prime brokerage arrangements, in which the client trades with non-U.S. affiliates of the prime broker under documentation that characterizes the transaction as a synthetic or swap-based trade rather than a direct margin loan. These structures often fall outside the technical scope of Regulation T, permitting greater leverage while still providing execution, custody, and financing services in a consolidated manner. Alternatively, many prime brokers offer portfolio margining, a risk-based margining framework that aggregates a client's positions across related strategies and asset classes to calculate margin requirements based on the overall risk profile, rather than applying a fixed percentage to individual trades. This approach, which is generally permitted for sophisticated institutional accounts, can significantly reduce required margin levels for hedged or diversified positions. From a legal standpoint, the use of portfolio margining requires appropriate account classification and may be subject to approval by the Financial Industry Regulatory Authority (FINRA) or other self-regulatory organizations.

Another core regulatory topic within prime brokerage arrangements is rehypothecation—the right of the prime broker to use, pledge, or otherwise transfer client securities posted as margin collateral. Under SEC Rule 15c3-3, broker-dealers are permitted to rehypothecate a customer’s fully paid or excess margin securities, but only within strict limitations. Typically, the aggregate value of customer securities that may be rehypothecated is capped at 140% of the customer’s debit balance. This regulatory limit is designed to ensure that broker-dealers retain sufficient collateral to meet their customer obligations and to limit the contagion risk that can result from excessive leverage or collateral reuse. While rehypothecation is a common and essential feature of modern prime brokerage, its operational and legal consequences are material. In the event of a broker default, rehypothecated securities may be unavailable for return, and clients must rely on their contractual rights and regulatory protections to recover their assets.

The Minimum Net Equity standard is another regulatory touchpoint that directly influences prime brokerage structuring. Pursuant to a 1994 SEC No-Action Letter, an investment fund seeking to establish a prime brokerage account must maintain a minimum amount of equity in the account: \$500,000 in cash or securities if managed by a non-registered investment adviser, and \$100,000 if managed by a registered investment adviser. These thresholds are designed to ensure that only sufficiently capitalized and regulated entities have access to prime brokerage services, thereby reducing the risk of undercollateralized accounts and improving systemic resilience. These minimum equity requirements are often embedded in the prime brokerage agreement and monitored as part of ongoing compliance, with breaches potentially giving rise to termination rights or margin calls.

Investor protection is a cornerstone of the U.S. broker-dealer regulatory regime, and the Securities Investor Protection Act of 1970 (SIPA) serves as the statutory foundation for customer asset protections in the event of broker-dealer insolvency. Under SIPA, customer accounts are protected for up to \$500,000 in securities (including a \$250,000 limit for cash claims), with the Securities Investor Protection Corporation (SIPC) serving as the receiver in the event of liquidation. SIPA protections are not intended to cover investment losses, but rather the loss or misallocation of customer property held in custody. SIPA also imposes specific requirements on the maintenance and segregation of customer assets, and a prime broker’s failure to comply with these obligations can result in significant enforcement exposure. Counsel advising clients should confirm the SIPC-member status of the broker-dealer and consider whether any additional private insurance or contractual protections are warranted.

In total, the regulatory framework governing prime brokerage activity is a nuanced combination of statutory restrictions, self-regulatory rules, and interpretive guidance. Each component—from margin lending to rehypothecation, capital thresholds, and insolvency protections—interacts with the others in ways that materially affect the structure, enforceability, and operational risks of the prime brokerage relationship. Legal advisors must therefore approach prime brokerage negotiations with a full appreciation of both the commercial dynamics and the regulatory landscape, ensuring that the contract's architecture reflects not only market standards but also compliance with a complex and evolving set of legal requirements.

In the next chapter, we turn to recent developments and market trends in prime brokerage, including the growing use of lock-up agreements, advances in collateral optimization, and the evolving relationship between hedge funds and their prime brokers in a world increasingly defined by liquidity stress and regulatory capital constraints.

Developments and Market Trends

The prime brokerage market, long defined by the provision of financing and custody services to hedge funds and other institutional clients, is a key central factor for most market participants and warrants monitoring and calibration to meet business and risk needs. Particularly in times of market volatility and stress events, buy-side clients should analyze their prime broker relationships and reassess the economics and risk management structures underlying their relationships. Notably the use of lock-up agreements, as well as recalibrations in pricing models, counterparty prioritization, and collateral optimization strategies may be warranted. These trends underscore the need for legal counsel to anticipate market realignment and adjust documentation and structuring practices accordingly.

Lock-up agreements—sometimes referred to as term agreements or committed funding arrangements—have long been aspirational enhancements to many client’s prime brokerage agreements (often only offered to select high value clients). Their use has been a significant innovation in the way prime brokers have historically managed counterparty exposure and allocate scarce balance sheet resources, which use has ebbed and waned in response to the volatility of the market and assessments of the prime broker’s exposure to its clients. These agreements generally involve a mutual commitment between the prime broker and the client under which the broker agrees to provide enhanced or stable margin terms, lending capacity, or financing rates for a specified term, such as 30, 60, or 90 days or more. In return, the client agrees not to move assets or trading activity to a competing prime broker during the lock-up period and may be required to maintain a minimum level of net equity, custody assets, or trading volume with the broker.

For prime brokers, lock-up agreements serve multiple purposes. They provide predictability in funding needs, support internal balance sheet planning, and enable the broker to justify more favorable pricing to preferred clients based on asset retention and commitment duration. In a post-Basel III environment, where regulatory capital charges have made uncommitted exposures more expensive, these agreements can significantly improve capital efficiency and reduce the volatility of funding outflows during times of market stress. They also provide a contractual mechanism for counterparty triage—allowing brokers to prioritize high-value clients during liquidity events, when asset recall and collateral harvesting become more pronounced.

For clients, particularly hedge funds and other leveraged asset managers, lock-up agreements offer the potential for better economic terms, enhanced liquidity certainty, and protection from abrupt margin requirement increases. However, these benefits are not without cost. Lock-up provisions can restrict a fund's operational flexibility, impede its ability to diversify counterparty risk, and entrench structural reliance on a single financing provider. From a legal standpoint, the terms of such agreements must be scrutinized carefully, particularly with respect to early termination rights, material adverse change triggers, and intercreditor coordination—especially where multiple brokers are involved.

Lock-up agreements also raise interesting tensions in the context of fund governance. A fund's obligation to tie up assets or financing capacity with a particular broker may require board or investor consent, depending on the fund's governing documents. In some cases, lock-up commitments may be seen as inconsistent with open liquidity promises to investors or may introduce potential conflicts of interest, particularly where fee sharing or revenue-based tiering arrangements are implicated. Legal counsel must therefore be attuned not only to the bilateral relationship between fund and broker, but to the broader ecosystem of fiduciary, regulatory, and investor-facing obligations.

More broadly, the increased prevalence of lock-up and term-based arrangements reflects a larger market trend: the bifurcation of prime brokerage services between high-priority and marginal clients. In an environment where broker-dealers face tighter internal credit controls and heightened regulatory scrutiny of risk-weighted assets, access to balance sheet resources is no longer purely a matter of transactional profitability. Instead, it is governed by holistic assessments of client value, which may include factors such as total wallet share, longevity of the relationship, compliance behavior, and strategic alignment with the broker's business objectives. This reality is driving a recalibration in how prime brokerage relationships are negotiated and maintained.

In addition to lock-ups, prime brokers are increasingly focused on collateral optimization and custody redesign. Legal documentation is evolving to accommodate more granular control over asset locations, eligibility criteria, and third-party segregation options. Clients are also demanding more transparency in how their assets are used, pledged, or rehypothecated—particularly in the wake of high-profile broker failures and liquidity mismatches. These trends are prompting a resurgence of interest in tri-party custody, enhanced asset tracking tools, and real-time collateral management platforms.

At the same time, regulatory developments—such as proposed SEC rules on customer protection, custody of digital assets, and fund liquidity risk management—are likely to impose new compliance obligations on prime brokers and their clients alike. Legal teams must continue to monitor how such changes impact operational procedures, documentation standards, and counterparty expectations.

In sum, the prime brokerage market is entering a period of strategic realignment, marked by increased emphasis on committed funding, client segmentation, and collateral efficiency. Lock-up agreements represent a key contractual innovation within this broader landscape, offering both opportunities and challenges for market participants. For legal practitioners, this evolution demands a forward-looking approach to structuring, negotiation, and governance, ensuring that prime brokerage documentation remains both commercially responsive and legally resilient in a shifting financial ecosystem.