Repurchase Agreement

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Found in 1969 and headquartered in Zurich, the International Capital Market Association ("**ICMA**") is a trade association and self-regulatory organization. The mission of ICMA is to promote resilient well-functioning international and globally coherent cross-border debt securities markets. In pursuit of its mission, it is committed to building trust in the market by promoting internationally accepted standards of best practice through the development of appropriate, broadly accepted guidelines, rules, recommendations and standard documentation.

The Securities Industry and Financial Markets Association ("**SIFMA**") started life in 1912 and is a leading US securities industry trading association representing securities firms, banks and assets manager in the United States of America. SIFMA serves as an industry coordinating body to promote fair and orderly market, informed regulatory compliance, and efficient market operations and resiliency.

A repurchase agreement is also known as "repo". Under a repo, there are two legs of transaction. In the first leg, the Seller shall sell, and the Seller shall, in the second leg, repurchase, securities. Simply put, the Seller sells securities to the Buyer for an agreed cash price. In the meantime, the Seller commits to buy back equivalent securities sold under repo from the Buyer on an agreed future date (see elaboration and diagram below).

The difference between the price paid by the Buyer in the first leg of a repo and the price he receives in the second leg of a repo is the return of the Buyer which is quoted as a percentage per annum rate and is called the repo rate.

General Master Repurchase Agreement

On 16th May 2011, ICMA and SIFMA published the General Master Repurchase Agreement 2011 (the "**GMRA**"). The documentation architecture of the GMRA is:-

(1) Master Agreement;
(2) Annexes consisting of:
(a) Annex I Supplemental Terms or Conditions;
(b) Annex II Form of Confirmation;
(c) Russian Annex;
(d) Agency Annex and Addendum;
(e) Bills Annex;
(f) Equities Annex;
(g) buy/Sellback Annex;
(h) Canadian Annex; and
(i) Indian Annex.

The parties may choose Annexes, which are not negotiated and amended normally, as may be necessary.

The commonly found features of the GMRA include:-

(1) Transaction is structured as outright sale and repurchase;
(2) Full title to securities and cash are transferred;
(3) The Buyer is obliged to return equivalent fungible securities (i.e. securities issued by the same issuer, of the same issue and the same nominal value but not the identically numbered securities the Buyer originally received);
(4) Provisions to regulate initial margin and top-up margin;
(5) The Seller is entitled to substitute securities margin with the Buyer's consent;
(6) The equivalent of the coupon received from the issuer of securities is paid by the Buyer to the Seller on the same day, if possible; and
(7) Legal title to collateral is robust.

Uses of repo

The traditional use of repo is to provide financing on a secured basis. Repo can also be used as an effective means of obtaining securities to cover delivery obligations under other transactions. A further use of repo is to provide leverage. In this context, the Seller may borrow cash under a repo to obtain most of the cash it needs to purchase a holding of securities.

Tri-Partite Repo

Tri-partite repo is a transaction for which post-trade processing (e.g. collateral selection, payments and deliveries, custody of collateral securities, collateral management and other operations during the currency of repo) is outsourced by the parties under repo to a third-party agent ("**Tri-Partite Agent**"). The Tri-Partite Agent can be a custodian bank, an international central securities depository or a national central securities depository. In Europe, the principal Tri-Partite Agents are Clearstream Bank Luxembourg, Euroclear Bank and Bank of New York Mellon. In the US, there is now only one Tri-Partite Agent, Bank of New York Mellon.

Collateral

In general, collateral under a repo should be free of credit and liquidity risk and demonstrate minimal correlation with the credit risk of the collateral-provider. The type of asset that would fall within this ambit, and is in fact the most commonly-used type of collateral in the repo market, are bonds issued domestically by central governments.

Legal issues

The key legal characteristics of a repo is that it is a outright sale and purchase agreement and not a sort of secured loan. With the outright sale, the legal and beneficial ownership of the securities under a repo are, in the first leg thereof, transferred to the Buyer in return for the payment of an agreed purchase price. The Seller has no further claim on the securities sold to the Buyer. Insofar as the second leg of repo is concerned, the Seller is only entitled to have a contractual right to repurchase the equivalent securities but has no ownership interest in them if the Buyer defaults on in the second leg of repo. The right to deal with the securities arises when full title to the repoed securities passes from the Seller to the Buyer, who is at liberty to sell them, repo them out to a third party or hold on to them to deal with them as the Buyer thinks fit.

An underlying principle of repo is that the interest of the Seller should not be prejudiced by a repo. Where the Buyer is in possession of full title of the repoed securities, the legal principle would uphold that the Buyer should be entitled to income derived from the repoed securities. Taking into account a repo is only a short-term transfer of securities, the market however considers it fair that the Seller should receive equivalent income from the Buyer.

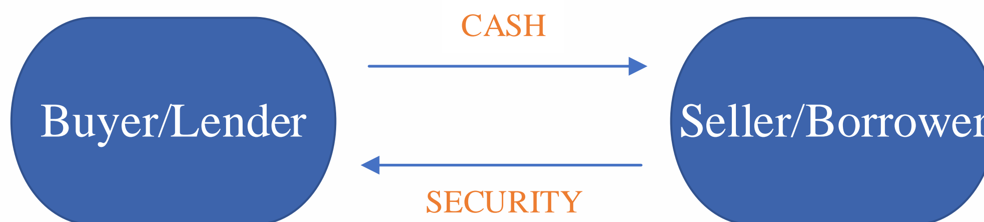
During the currency of a repo, the Buyer holds legal title to the collateral. In other words, he is entitled to any benefits of ownership. In the case of securities, and sometimes corporate bonds, the benefits of ownership may include voting rights. The Buyer can, if he wishes, vote in accordance with the wishes of the Seller but he is under no obligation whatsoever to do so. However, while the buyer obtains any rights to vote that are attached to collateral securities, it is unacceptable under corporate governance recommendations to use repo to buy securities for the sole purpose of exercising the voting rights given that the Buyer is only a short-term holder of repoed securities.

Paragraph 8 of the GMRA provides that the Seller shall have right to substitute repoed securities with new repoed securities which are different provided that the Buyer consents. The Seller may do so if he desires to have the repoed securities back early for a commercial reason while he does not intend to terminate the repo itself.

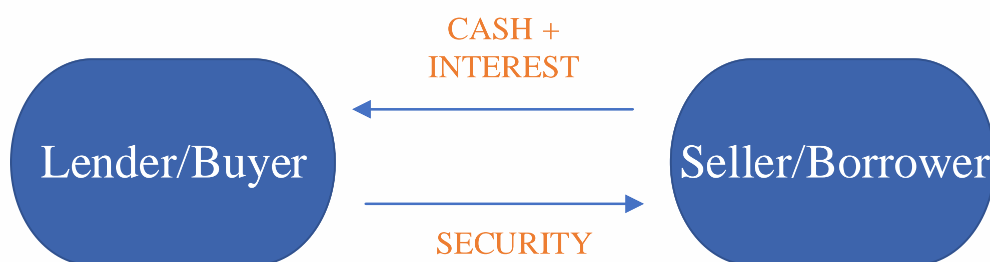
Where, following the Seller's default or insolvency, the Buyer sells the securities on the open market and obtains less than the repurchase price, he will base his residual claim on cash compensation and not refer to unpaid indebtedness.

While a US bankruptcy court held that repo is a case is a secured loan for bankruptcy purpose, no case in the English court ruled that a repo is a secured loan. In the event that a repo has been recharacterized as a secured loan, the Buyer who had entered into a repo to cover a short position would not be in a position to pass the securities unencumbered to its client. Further, the Buyer can only force his rights in the prescribed legal procedures and may find himself subject to a moratorium or other creditors.

First Leg



Second Leg



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Should you have any questions, please contact our partner Mr Lawrence Yeung at (852) 2854 3070 or by email at lawrence.yeung@ycylawyers.com.hk.