A Primer on Sponsored Repo for the Buy-Side

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Recent expansions of the Depository Trust and Clearing Corporation's (DTCC) sponsored repo service for Treasuries and agency debt have sparked interest among both buy-side and sell-side repo participants. For the buy-side firm, sponsored repo:

- provides the firm with DTCC's direct guaranty as a central counterparty, almost eliminating dealer credit risk, without obligations to contribute to DTCC liquidity or loss requirements;
- reduces the firm's reliance on dealers, allowing the firm to potentially access any DTCC member as a repo counterparty;
- allows the firm to avoid bank balance sheet and liquidity constraints; and
- may result in tighter pricing.

In sponsored repo, an existing, well-capitalized, full member of DTCC's Fixed Income Clearing Corporation – Government Securities Division ("FICC") (mostly dealers and banks are approved by FICC) (a "Sponsoring Member") agrees to be responsible for the repo trades made through FICC by its customer (the "Sponsored Member"). The Sponsored Member can be any qualified institutional buyer (QIB) worldwide, subject to FICC's discretion to approve such QIB as a Sponsored Member and legal restrictions such as government sanctions.

Once approved by FICC (a process that normally takes a few months from filing the application with FICC plus any time needed to complete operational and IT installations), the Sponsored Member is assigned a special FICC member number allowing it to submit trades through the Sponsoring Member's omnibus account for sponsored repo customers. The omnibus account is segregated from the Sponsoring Member's proprietary account; however, if the Sponsoring Member is liquidated by FICC, positions in the omnibus account will be liquidated also and cash net amounts will be paid to the Sponsored Members in place of securities and cash balances.

A Sponsored Member can trade Treasury or agency debt repo under the special member number with the Sponsoring Member or, if the Sponsoring Member permits, with a third party. MBS and non-agency debt are not eligible for the sponsored repo service. All trades using the Sponsored Member number are automatically processed and cleared by the Sponsoring Member as agent and, when they are accepted for FICC clearing, are novated to FICC as central counterparty. The Sponsoring Member is responsible for all clearing and settlement on both the start leg and close leg on behalf of the Sponsored Member, and guarantees performance by the Sponsored Member. Thus, the decision to sponsor a member is heavily influenced by credit and compliance considerations. The Sponsoring Member is also responsible for making or receiving any margin payments on term repo positions, although it will recoup or remit those payments to the Sponsored Member in accordance with the terms of their agreement. Finally, the Sponsoring Member is solely responsible for loss mutualization, contingent liquidity requirements and clearing fund contributions attributable to the Sponsored Member's activity; pricing of sponsored repo services will reflect those obligations as well as operational costs.

When trades are novated, the Sponsored Member becomes the legal counterparty of FICC and the original repo counterparty steps out of the picture. FICC performs the close leg of the repo. Because the start leg of most sponsored repos settles before the novation takes effect, FICC will not guarantee performance on the start leg (but FICC does not do so for most other types of repo either).

Banks and their affiliates, which are subject to prudential constraints on balance sheet positions, liquidity requirements, and counterparty concentrations, have frequently been unwilling or unable to provide repo liquidity at stress periods such as quarter ends. The largest banks are promoting sponsored repo as a method of assuring customers better liquidity while ensuring that they will retain those customers given the operational and credit difficulties of moving from one Sponsoring Member to another. Some stand-alone broker-dealers, which are not subject to the onerous prudential requirements, are reluctant to offer sponsored repo, either because they prefer to maximize proprietary deal flow, wish to avoid the additional operational complexity, do not wish to take on the contingent obligations or are unable to meet FICC's capital requirements for Sponsoring Members.

To participate in sponsored repo a buy-side firm must:

- make substantial investments in operational and IT facilities, and possibly hire trading desk personnel with more relevant experience;

- enter into additional documentation with DTCC and the Sponsoring Member and agree on compensation for the Sponsoring Member's services;

- make arrangements for posting collateral and making transaction balances and deliverable securities available to the Sponsoring Member; and

- effect a complex set of bookings for each sponsored repo trade.

The operational requirements for sponsored repo can include without limitation, setting up a separate trading entity, adding electronic communication network (ECN) capability, cash and rate monitoring systems, addressing booking complexity, intra-day transfers to and from custodians, end of day netting comparison and possibly allocation algorithms for delivery of securities. Finally, the Sponsored Member must meet FICC business continuity and disaster recovery requirements, and may have to participate in periodic drills.

As a result, sponsored repo may be attractive only for larger institutional investors and investment managers, who can amortize the costs over many clients or trades.

Questions regarding sponsored repo agreements and all other types of repo and securities financing may be directed to either GuyLaine Charles at guylaine@charleslawpllc.com or Joseph Heyison at joe@charleslawpllc.com. This client update is prepared for the general information of our clients and other interested persons. It is not, and does not attempt to be, comprehensive in nature. Due to the general nature of its content, it should not be regarded as legal advice. If you have not received this publication directly from us, you may obtain a copy of any past or future publications by sending an e-mail to castle@charleslawpllc.com.