Counterparty Risk Management Practices with Respect to Tri-Party Repurchase Agreements

The Financial Stability Oversight Council (“FSOC”), in its May 2013 Annual Report, highlighted certain potential financial stability risks in the tri-party repurchase agreement market (commonly known as the “tri-party repo market”) if concerns emerge regarding the financial condition of borrowers in this market, such as securities broker-dealers. Money market funds have significant portfolio holdings of tri-party repos (approximately $591 billion at the end of 2012). Even though many money market funds may stop rolling over repo holdings of a counterparty that comes under financial pressure, it is possible that a money market fund could face the sudden default of a tri-party repo. Accordingly, as a matter of prudent risk management, money market funds and their investment advisers are encouraged to consider the legal and operational steps they may need to take if a repo counterparty fails and the repos it issued default. The staff notes that while many different kinds of mutual funds may hold tri-party repos (and thus this staff guidance note may be useful to mutual funds generally), the staff is addressing this communication largely to money market funds because these funds tend to have more significant portfolio holdings of tri-party repos than other types of mutual funds.

There are a variety of ways in which a money market fund and its adviser may be able to prepare in advance for handling a default of a tri-party repo held in the fund’s portfolio. Such advance preparation could be part of broader efforts by the money market fund and its adviser to follow best practices in risk management and engage in appropriate advance planning to be prepared for the default of any type of portfolio security. For example, a fund’s adviser may:

- Review the master repurchase agreements and related documentation to consider any specified repo default procedures. If these procedures call for the fund or its adviser to provide any notifications, instructions, or other types of forms or information to agents or custodians, the fund may want to consider having templates of such notifications or other documents prepared in advance to the extent practicable.
Consider operational aspects of managing a repo default. For example, funds may want to evaluate whether the systems at the fund or its custodian are capable of appropriately holding, valuing, trading and accounting for the collateral underlying the fund’s repos. If they are not capable, funds may want to consider what systems changes or temporary measures could allow for such capabilities and what other operational impacts may flow from the fund holding the collateral, as opposed to the repo.

Consider, to the extent possible, whether there are potential legal considerations under the Investment Company Act or otherwise that the fund could consider in advance or will need to evaluate at the time of any repo default. For example, money market funds may want to consider whether they can hold certain types of repo collateral and remain in compliance with rule 2a-7 under the Investment Company Act of 1940. The funds also may want to identify any required notifications to the SEC as a result of a default. Funds also may want to determine whether the defaulted repo would be subject to any automatic stays under either the U.S. Bankruptcy Code or federal banking laws and regulations. In addition, if the default were subject to an automatic stay, the fund may want to consider the impact that such a stay might have on the fund. Finally, the fund may want to evaluate what notifications and information the adviser should provide to the fund’s board of directors regarding the default, and what disclosures, if any, the fund should provide to its shareholders.

A repo counterparty default could create adverse consequences for fund shareholders. The staff recognizes that it is not practical to expect money market funds to plan for every contingency that can arise from the default of a tri-party repo portfolio holding. Nevertheless, appropriate advance planning for portfolio defaults may help funds manage such adverse events more smoothly and lessen the chance that such a default has harmful effects that could have been ameliorated.

Endnotes

1 2013 Annual Report of the Financial Stability Oversight Council, at pages 4, 12-13, 133-134. See also Brian Begalle et al., The Risk of Fire Sales in the Tri-Party Repo Market, Federal Reserve Bank of New York Staff Report No. 616 (May 2013) (discussing concern that stress caused by a potential default of a tri-party repo counterparty can lead to either pre-default fire sales of assets by the counterparty or post-default fire sales of collateral by the tri-party repo investor and the related financial stability concerns). The tri-party repo market refers to the market for repurchase agreements in which a clearing bank acts as third-party agent to
provide collateral management services and to facilitate the exchange of cash against collateral between the two repo counterparties.

2 Based on Form N-MFP data. The tri-party repo market financed close to $2 trillion of securities at the end of 2012. See http://www.newyorkfed.org/banking/tpr_infr_reform_data.html.


4 See, e.g., a checklist that the Investment Company Institute has prepared for funds holding repos in the event of a repo counterparty insolvency at http://www.ici.org/policy/current_issues/11_mmf_repo_checklist.

5 For example, some collateral underlying repos in money market funds’ portfolios would not be “eligible securities” under rule 2a-7 that the money market fund could hold. In other cases, the money market fund holding the collateral may cause the fund to violate its obligations under rule 2a-7 relating to maturity, liquidity, or diversification. The staff notes that these risks apply to the default of any secured debt obligation held by a money market fund.

6 Currently, under rule 2a-7(c)(7)(iii), a money market fund must promptly notify the Commission by electronic mail directed to the Director of the Division of Investment Management or the Director’s designee of any default or event of insolvency of any portfolio security, and the actions the money market fund intends to take in response to such event, where immediately before the default, the security represented ½% or more of the money market fund’s total assets. Under proposed changes to the Commission’s rules regulating money market funds, a money market fund would have to publicly report such defaults or events of insolvency on a new reporting form (Form N-CR) within one business day after the default or event of insolvency. See Money Market Fund Reform; Amendments to Form PF, Investment Company Act Release No. 30551 (June 5, 2013).

7 See, e.g., 11 U.S.C. §§ 362(a) (U.S. Bankruptcy Code automatic stay provision). But see also 11 U.S.C. § 362(b)(6), (b)(7), (b)(17) (containing certain exceptions from the automatic stay for certain financial contracts known as “qualified financial contracts” (QFCs)). Repurchase agreements (and reverse repurchase agreements) are QFCs and in general are not subject to the automatic stay. See 11 U.S.C. § 559.
QFCs are also defined under Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), Pub. L. No. 111-203, § 210(c)(8)(D)(i). Title II of the Dodd-Frank Act provides that a person who is a party to a QFC with a “covered financial company” (i.e., a financial company that has been placed into orderly liquidation under Title II of the Dodd-Frank Act) may not exercise any termination rights solely by reason of the appointment of the Federal Deposit Insurance Corporation (FDIC) as receiver for that company under Title II (i) until 5:00PM on the business day following the date of the FDIC’s appointment; or (ii) after the person has received notice that the QFC has been transferred to another party. See Dodd-Frank Act, § 210(c)(10)(B)(i)(I)-(II).

This IM Guidance Update summarizes the Commission staff’s views regarding various requirements of the Investment Company Act of 1940 and/or the Investment Advisers Act of 1940. Future changes in laws or regulations may supersede some of the discussion or issues raised herein. This IM Guidance Update is not a rule, regulation or statement of the Commission, and the Commission has neither approved nor disapproved of this IM Guidance Update.

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- protect investors
- promote informed investment decisions and
- facilitate appropriate innovation in investment products and services
through regulating the asset management industry.

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