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Third parties in repo transactions (Repos)

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Abstract

***Research Purpose:** This paper explores the specific aspects of repo transactions, focusing on instances where third-party involvement, in the authors' view, has the most significant impact on their structure.*
***Design/Methodology/Approach:** The research uses the theoretical approach to examine the involvement of third parties in repo. Empirical findings from Latvian repo contracts, which highlight key contractual challenges, and insights from expert interviews on tri-party repo are also used.*
***Findings:** The involvement of third parties in repo has significantly increased due to the revolution in settlement methods for both money and securities. A theoretical approach indicates that constructing a clear and legally correct repo contract requires not only legal expertise but also experience and a comprehensive understanding of the transaction. On the empirical side, it is evident that having experience and understanding of how repo works without deep legal knowledge does not necessarily guarantee that the contract will be legally correct and not misleading. Moreover, some amendments in the law are required to liquidate existing discrimination of certain types of repos.*
***Originality/Value/Practical Implications:** The first Latvian study offering a theoretical basis to support development, to foster understanding and to prevent mistakes.*

Keywords

repo • third parties • repos • settlement

INTRODUCTION

The aim of this paper is to examine the involvement of third parties in repo, particularly focusing on situations where the actions or engagement of third parties, by the opinion of the authors, have the most significant impact on the repo transaction and its structure.

To achieve the aim of this paper, various scientific methods are used. Analysis and synthesis are employed to identify, analyse and describe problematic issues and results. The qualitative research method is utilised to study empirical material, while deduction is applied to quantify the qualitative analysis results. Expert interviews are conducted to clarify specific aspects of the problematic areas. However, specific conclusions drawn from an empirical study of Latvian repo contracts are employed to illuminate the challenges inherent in these contracts. The authors examine repo transactions concluded in accordance with the contracts between professional counterparties (financial institutions) and customers of financial institutions.

The transactions are the basis of contemporary commercial relationships, but the law is the basis of the transactions. Due to the technological revolution, modern transactions are almost inconceivable without involvement of third parties, that is, persons who are not counterparties to the transaction. The variety of ways in which third parties can participate in a transaction could be the subject of a separate monograph research. This article examines the participation of third parties in repos and explains some nuances associated with such participation. Additionally, it addresses errors identified in the description of transactions based on findings from an empirical review of the contracts used in the Latvian market.

From an economic perspective, repo involves a lender, a borrower, cash and collateral (Sissoko, 2019), and a rate. (López et al., 2017), but from the legal perspective the transaction is structured as two sale purchase transactions (legs) (Gottardi et al., 2019) (Figure 1), and could be defined as 'the sale of securities with an agreement to repurchase them at a specified future date' (Schultz and Bockian, 2017).

In the past, counterparties could only commit to a transaction in person, following a complex ritual for its conclusion. However, in contemporary times, it is challenging to imagine a situation where a commercial transaction cannot be concluded through representatives, and where third parties are not involved in fulfilling the obligations arising from

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the transaction. The increase in third-party involvement in commercial transactions has been influenced by a combination of various factors. These include the heightened complexity of the characteristics of economic relationships, legal forms and subjects of transactions, as well as shifts in principles and the speed of settlement.

Third parties may participate in a repo at different phases of the transaction and their activities may take different forms. For instance, during the preparatory phase of a repo, that is, before entering into the transaction, third-party involvement may take the form of practical actions—searching for the counterparty to the transaction or legal actions, such as entering the transaction on behalf of one or both counterparties. During the execution phase, the participation of a third party may take the form of either executing the obligation instead of the debtor or accepting execution instead of the creditor. Such activities may be either 'primary', that is, where the third party itself executes or accepts the execution, or 'supporting', where the third party either directly or indirectly supports transaction. The basis of such supporting activities is an agreement between the counterparty and the supporting third party. However, in certain circumstances a direct contractual basis cannot exist; for instance, when various institutions are involved in supporting activities, such as transfer of securities (Figure 2) or transfer of funds.

Repo agreements in which a third party acts on behalf of both the repo counterparties are widely used in the international financial market. Such repo agreements are known as a tri-party repo. It should be pointed out that in tri-party repos the third party is not a counterparty to the repo transaction. The name 'tri-party repo' may, to some extent, be misleading as to the number of counterparties involved in the repo transaction. The basis for the third party's activities in a tri-party repo does not derive from the repo transaction, but from a separate independent ancillary contract, which could be incorporated into the agreement governing the repo transaction (Choudhry, 2010).

A tri-party repo does not constitute a multi-party transaction; rather, it involves two counterparties, akin to a standard repo agreement. The legal framework of a tri-party repo entails two distinct contracts: a repo agreement facilitating the transaction itself, and a tri-party agreement among the buyer, the seller and a third party responsible for administering the settlement or servicing the transaction (Figure 3).

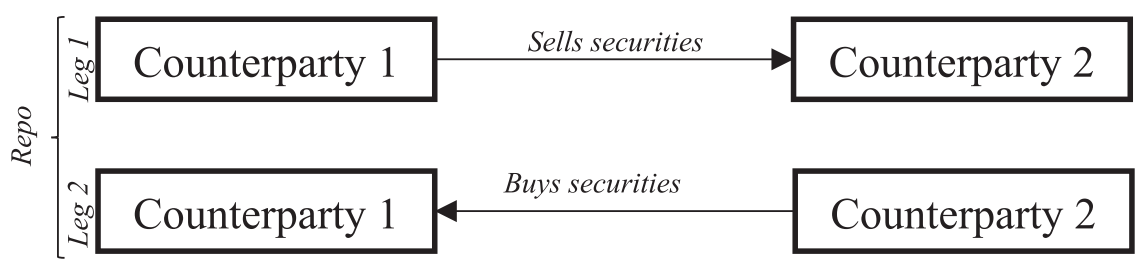

Figure 1. Structure of Repo.
***Source:* Authors.

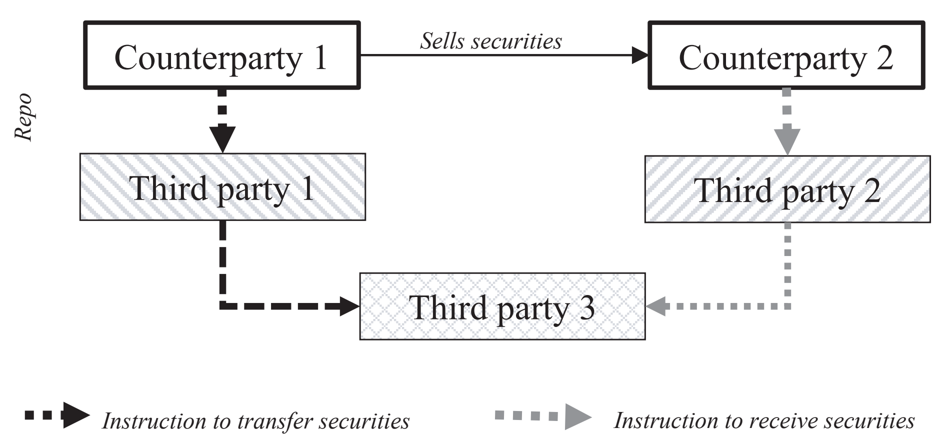

Figure 2. Third parties ensure transfer of securities.
***Source*: Authors.

In essence, a tri-party repo differs from a classical repo by the settlement model, that is, the technical execution of the transaction involving a third-party intermediary, which ensures risk mitigation (Adrian and Begalle, 2012), that is, greater settlement certainty, and the mutual fulfilment of obligations on a DVP basis; in other words only if both parties to the transaction have provided the necessary quantity of assets (securities and cash) to a third party (Dufour et al., 2020).
In the United States, tri-party repo is offered by large credit organisations, such as the Bank of New York Mellon and JP Morgan Chase, in Europe by Euroclears and Clearstrims, leading Central Securities Depositories (CSD), and in Switzerland by SIX. Unfortunately, NASDAQ CSD SE Baltic CSD does not publicly offer such a service as triparty repo service. In the context of studies of repo under the discourse of repo transactions, following common features of the *fiducia* and repo are extremely important: transfer and retransfer of the ownership and distribution of the profit gained during transaction.

LITERATURE REVIEW

Typically, contemporary literature predominantly delves into the economic facets of repo transactions and repo markets, focusing on elements such as interest rates (Arrata et al., 2020), collateral management (Bicu-Lieb et al., 2020; Bradford (2012), dynamic and liquidations (Barbiero et al., 2022), and impact on financial markets (Breton and Ben- Abdallah, 2018; Corradin and Maddaloni, 2020; Huh and Infante, 2021; Sissoko, 2019). Paradoxically, scant attention is directed towards the transactions themselves and their constituents, particularly in a non-mathematical context. Notably, there exists a conspicuous dearth of literature dedicated to scrutinising the distinct features of repo transactions concerning third-party involvement. However, some papers deal with the features of so-called Tri-Party Repo (Copeland et al., 2014), or describe problematics of Central Clearing Counterparties (CCP) (Adrian and Ashcraft, 2012; Berndsen, 2021; Mcvea, 2017). However, it is noteworthy to mention publications like Wansleben (2020) 'Formal institution building in financialized capitalism: the case of repo markets', which, to some extent, align with the focus of these papers. This is particularly true as Wansleben's research delves into the sociological approach to the evolution of repo transactions and their structure, but these papers delve into the legal aspects of repo transactions. Legal researches of repo are very rare and the volume of legal literature is limited. Some aspects of problematics can be found in the papers devoted to the insolvency or securities sales issues (Antinolfi et al., 2012), especially in connection with the Lemont Brothers cases (Burke and Burke, 2019; Hines et al., 2011), or aspects of non-fulfillment of obligations (Wibowo and Henni, 2023)

RESEARCH METHODOLOGY

Initially, through a review of the literature and theoretical studies, the authors identified the various ways in which third parties may participate in repo transactions. Subsequently, they investigated the main points associated with such participation. To substantiate their position and conduct market studies of the contracts, they selected 1 July 2017, as the reference point for the study of the market structure and for identifying the offering of repo 'as a product' in the Latvian market.

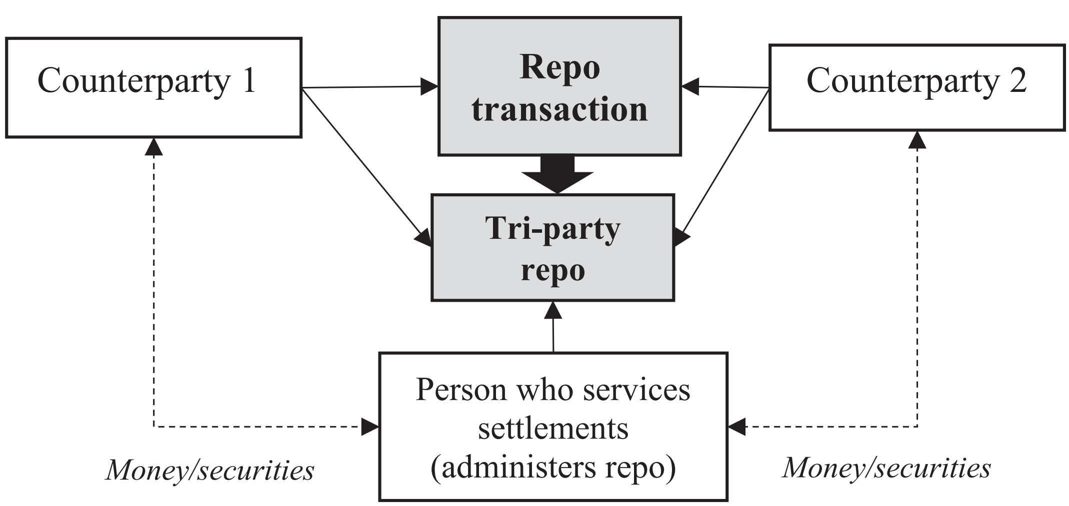

Figure 3. Structure of tri-party repo.
***Source*: Authors.

Drawing upon a deep practical knowledge of the capital market's relevant law, the authors identified potential market participants (types of financial institutions capable of offering the 'repo as a product'). They then utilised publicly available data on the types of licenses issued to these financial institutions by Latvian Financial and Capital Markets Commission (now Bank of Latvia) to determine which entities are entitled to offer 'repo as a product'. Subsequently, publicly available information on repo offerings was analysed.

To clarify the stance of other financial institutions, the authors employed the unstructured expert interview method. Unstructured expert interviews were conducted with 10 expert respondents, comprising two distinct groups. The first group consisted of four lawyers, each with an average legal experience of at least 19.5 years, including at least 13 years of experience specifically in the legal support of investment services within financial institutions. The second group comprised six experts directly involved in the provision of investment services or compliance support, with an average experience of 15.5 years in their respective fields. All respondents verbally agreed to answer the questions and were informed about the scientific and research purposes of the interview. They were also assured that their personal data would be anonymised and not presented in the study. However, despite these assurances, some respondents declined to answer individual questions, citing confidentiality concerns. Others provided only brief responses, which hindered the possibility of continuing the interview. The remaining information was gathered from financial institutions through hotline calls. It was determined that repo 'as a product' had been offered by 11 institutions (see Table 1).

Then the collection of empirical data was undertaken, yielding information on 11 institutions, which represented 100% of the market for repo offerings. Subsequently, the authors conducted qualitative analysis of the empirical materials and applied deductive techniques to quantify the results of the analysis.

To clarify some peculiarities of the Latvian market's tri-party repo, special expert interviews were conducted. The interviews were conducted over phone in accordance with the Unstructured Interview Programme (UIP). All respondents verbally agreed to answer questions and were informed about the research purpose, as well as the anonymisation of personal data, which would not be presented in the study. The interviews were conducted with eight experts, who were individuals with >10 years of experience in the capital market. Among them, six were industry representatives (from financial institutions: five banks and one investment firm) and two were representatives of the regulator. Each expert contributed to the development (supervision) of financial institution policies within their respective competencies and had access to information about the range of services provided and the institution's operations. None of the respondents stated that they lacked access to information about the possibility of engaging in tri-party repo transactions. The question of offering the repo on the Latvian market was a part of the interview.

RESEARCH RESULTS AND DISCUSSION

The structure of a repo is quite complex. Legally, one and the same counterparty is both the creditor and the debtor in each leg of the transaction. For the purposes of this paper, a debtor is a counterparty that performs any active actions (executes), such as making a payment or delivering securities at a certain leg of the repo. Conversely, a creditor is a counterparty receiving execution: payment or securities for the same leg of the transaction. Third parties may participate in a repo transaction: (a) on the creditor's part; (b) on the debtor's part; and (c) both on the creditor's and debtor's parts.

A third party participating in a repo transaction on the creditor's behalf may accept execution instead of the creditor, for instance, in cases of redirected execution, that is, when the debtor must execute the obligation not to the creditor but to a person indicated by the creditor. In such cases, the structure of the counterparties to the transaction does not change, as the creditor still has the right to enforcement, while only the person to whom the debtor must provide execution changes.

The literature suggests that the personality of the creditor in a repo transaction is considered unimportant, since the creditor is expected to receive execution only (Khliustov, 2013). The authors argue that this opinion is overly hypothetical, because it is challenging to envision scenarios where securities would

Table 1. Repo as a product offering (*Source:* Jukna, T.)

Type of the financial institution	Repo offering		Not entitled	Total
	Yes	No		
CI	10	5	1	16
Branches of CI	0	3	2	5
Investment companies	1	0	3	4
Total	**11**	**8**	4	**25**

CI, credit institutions.

be transferred to the ownership of the third party. The authors stand on the position that ownership on the securities in repo must be passed to the creditor, otherwise the transaction ceases to be repo. Ownership rights on securities are transferred at the moment when securities are recorded in the receiver's account (Art. 125(1), Financial Instrument Market Law of Republic of Latvia 11), and it goes in line with the system of intermediated holding of securities (Jukna and Grasis, 2022). This implies that securities should be recorded in the creditor's account, rather than in the account of a third party. The transfer creates an electronic record in the account, confirming that the securities are owned by the creditor. This specific moment marks the completion of the execution. The moment of transfer of ownership rights is unalterable and imperative. This signifies that it cannot be modified or changed under practical circumstances. The similar strictly imperative approach to the transfer of ownership on real estate is used (Dinsberga and Bite, 2018). However, empirical results of Latvian contractual practise research discovered that some banks are trying to circumvent those imperative provisions, either to enhance the saleability of repo 'as a product' or to enhance their own protection. Our study shows that only 45.5% of institutions reflected the transfer of the ownership rights on securities correctly; 36.4% of institutions consider that ownership rights are transferred at the moment of payment for securities, and the remaining 18.1% consider that ownership rights on securities are not transferred.

It is important to note that providing instructions for payments to a third party increases the risk of disputes for the party making the payment to the third party instead of directly to the counterparty. If, because of redirection, the debtor incurs additional expenses, the creditor is obligated to reimburse them to the debtor. The right to recover additional costs derives from the general duty to compensate for any loss that person suffers because of the conduct of the other counterparty, and in this case any costs over and above the ordinary costs that the debtor has agreed to incur in the standard execution constitute losses of the debtor that the creditor must reimburse. In general, the execution is valid if it is provided to the creditor or his legal representative (Art. 1816 of Civil Law of Republic of Latvia 20 (CL)). The Latvian law does not contain a separate provision on the debtor's right to require verification of the representative's authority, but if the execution is provided to a person who is not entitled to the execution, the debtor is not released from the debt (Art. 1817, Civil Law of Republic of Latvia 20). The redirection of execution in this case is no different from the situation where the debtor must provide the execution to a new creditor who has obtained his rights as a result of the assignment, since in principle such a change is also a necessary element of the assignment for the debtor to fulfil his obligations. In his article 'The Legal Significance of the Notice of Assignment', Kalniņš (2015), discussing the problems of assignment, pointed out that 'the assignee, having regard to the provisions of Articles 1816 and 1817 of CL, is not entitled, *inter alia*, to refuse to submit to the debtor a "special document" drawn up in accordance with the provisions of Article 1802 of CL (respectively, a written assignment agreement) or an inscription of the assignment on that document'.

The statutory law does not indicate the legal consequences if a person specified by the creditor refuses to accept execution. Authors argue that the creditor must accept consequences, but the actions of the third party should be recognised as the own actions of the creditor. This approach corresponds to the principle included in Article 1547 of CL: 'if somebody promises [...] that third person will execute something […] this means that such action is the own action of the person who give a promise and this person will compensate for losses if the third persons will not execute'. The redirection issued by creditor to the debtor shall be recognised as promises of the creditor that the third person will execute the promises—accepts the execution from the debtor.

Another potential scenario for a third party to participate in a repo, this time on the debtor's part, is the execution of the obligation on behalf of the debtor. If the provisions of the repo do not explicitly state that the obligation must be executed exclusively by the debtor personally, the debtor has the right to delegate the execution of the obligation to a third party. In essence, this results in re-authorisation to execute the obligation. Similar to the redirection of execution, the overall structure of counterparties in the transaction remains unchanged. However, there is now a third party from whom the creditor must accept execution instead of the debtor.

It should be emphasised that a debtor, executing its obligations through a third party, remains liable and bears the risk of non-execution or improper execution. In such cases, the execution by a third party, who is not legally bound to the creditor under the contract, is an act of the third party's own will, and the creditor is not affected by the legal relations established between this third party and the debtor. Furthermore, the third party may execute the debtor's obligations without the debtor's knowledge or even against the debtor's will (Art. 1815, Civil Law of Republic of Latvia 20), and the creditor must accept such execution if there are no legitimate reasons for refusal (Art. 1837, Civil Law of Republic of Latvia 20). Consequently, this raises the broader problematic of both the redirection of execution and re-authorised execution, which includes the acceptance of execution from a third party. In other words the reason for refusing execution in favour of a person specified by the creditor and accepting performance from a third party instead of the debtor should be legitimate.

Legitimate reasons for refusing execution may arise from a counterparty's doubts about the good faith of another counterparty or a third party. However, it is important to note that in case of a dispute, the burden of proof lies with the counterparty expressing doubts. The basis for these legitimate reasons is rooted in Law on the Prevention of Money Laundering and Terrorism and Proliferation Financing of Republic of Latvia (MLR) (Law on the Prevention of Money Laundering and Terrorism and Proliferation Financing of Republic of Latvia 30). This MLR mandates regulated entities to abstain from establishing business relationships, including informal ones, with individuals who do not meet the counterparty's risk tolerance criteria. Furthermore, regulated entities are required to refrain from engaging in transactions with such persons, demand early execution of obligations and be exempt from civil liability if they have acted in good faith (Articles 28(2), 28(3), 40(2), 40(3), Law on the Prevention of Money Laundering and Terrorism and Proliferation Financing of Republic of Latvia 30). Another significant question arises when the creditor of the counterparty is confronted with a conflict of interest. On one hand, there is a desire to accept execution from a third party to avoid potential losses. On the other hand, there is a need to refuse execution to comply with MLR regulations aimed at preventing transactions involving funds of 'unknown origin' in the financial system of the Republic of Latvia. In such cases, the law does not protect actions contrary to legal requirements or ethical standards. Specifically, in situations where 'the state, for public law purposes (such as the prevention of money laundering), requires a credit institution (CI) to refrain from execution of obligations assumed in private law relations' (High Court of Republic of Latvia, 2008), the creditor counterparty must abstain from accepting of execution from a third party if there are doubts about the good faith of the debtor or the third party. The regulatory framework currently in force in Latvia does not allow for direct, actual and legal participation of a third party in a repo transaction, either on the creditor's side or on the debtor's side, as provided, for instance, in Article 51.3.18 of the Law of the Russian Federation 'On Securities Market' (Federal Law of Russian Federation 22). An analysis of the relevant article leads to the following conclusions: (a) The third party involved in the transaction does not act as a counterparty to the repo transaction, and the legal basis for its actions is outlined in another agreement. However, the third party receives information about the essential components of the repo transaction; (b) the primary role of the third party is to ensure the security of fulfilling obligations arising from the repo, including the settlement and protection of counterparties' rights; (c) the absence of a provision of similar content cannot be considered as a deficiency of the Latvian regulatory framework. First, counterparties in a repo are entitled to freely negotiate and enter into a similar agreement with a third party. Second, counterparties to the transaction have entered into written agreements (Art. 126, Financial Instrument Market Law of Republic of Latvia 11) with investment service providers, who, in executing counterparties' instructions, ensure both settlements for concluded repo transactions and the protection of other investors' rights. In practice, three agreements are concluded in Latvia instead of two. The Latvian regulatory framework does not prohibit counterparties from expressing their intentions and reaching an agreement by concluding a tri-party agreement. Such an agreement would define the scope of obligations of the third party (intermediary) regarding the settlement of repo transactions.

There is no available information indicating that Latvian investment service providers publicly offer tri-party repo. However, based on the author's experience, there are occasional requests to facilitate settlements for repo transactions concluded between two non-investment service provider entities, although such requests are relatively rare. It is noteworthy that local financial institutions, at the operational level, often do not acknowledge or utilise the term 'tri-party repo' to describe the standard legal framework. Instead, they facilitate settlements based on submitted documents and client instructions, similar to their practices within transaction account agreements, where they act as trusted intermediaries. Our expert interviews in 2019 revealed that using the term 'tri-party repo' when requesting services from financial institutions in Latvia tends to create confusion rather than provide clarity about the desired service. Nonetheless, it is important to mention that approximately 30% of respondents are familiar with and comprehend the fundamentals of tri-party repo transactions.

The prohibition of repo transactions between an investment service provider and a private client arises from the prohibition of title transfer collateral arrangements. However, this prohibition does not apply to tri-party repo transactions, as the investment service provider, when facilitating settlements, does not acquire ownership rights to the securities themselves. Moreover, the investment service provider may act as an authorised representative of the pledgee to make the necessary entries in the pledgee's account. However, Latvia's Financial Collateral Law (Financial Collateral Law of Republic of Latvia 11) applies only to financial collateral if one of the pledgees is mentioned in the first part of Article 3 of the law, but in a tri-party repo transaction, two pledgees are involved, and the financial institution (investment service provider) is not a direct pledgee in the transaction but only the authorised representative of the pledgees; this means that direct parties to the transaction are not protected from the perspective of the law.

CONCLUSIONS

A theoretical approach indicates that constructing a clear and legally correct repo contract requires not only legal expertise but also experience and a comprehensive understanding of the transaction. On the empirical side, it is evident that having experience and understanding of how repo works without deep legal knowledge does not necessarily guarantee that the contract will be legally correct and not misleading.

Therefore, it is recommended to expand the second part of Article 3 to allow for application of the Financial Collateral Law provisions to collateral provided by the pledgees who are not the subjects mentioned in the first part of Article 3. This is on condition that the subject mentioned in the first part of Article 3 (the Subject) is the authorised representative of the pledgee, who ensures the maintenance of the pledgee's account and provides evidence of the provision of financial collateral. The participation of the Subjects in ensuring transaction settlements reduces the risk of fictitious transactions, which is why the exclusionary provision is not applied to small- and medium-sized enterprises, as well as to consumer transactions. The amendment of the law will liquidate the discrimination of repo transactions concluded between non-financial counterparties.

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