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March 28, 2014

VIA ELECTRONIC MAIL
Marcia E. Asquith
Office of the Corporate Secretary
Financial Industry Regulatory Authority
1735 K. Street, NW
Washington, DC 20006-1506

RE: FINRA Regulatory Notice 14-02: FINRA Requests Comment on Proposed Amendments to FINRA Rule 4210 for Transactions in the TBA Market

Dear Ms. Asquith:

On behalf of the Bond Dealers of America (BDA), I am pleased to submit this letter in response to the Financial Industry Regulatory Authority's (FINRA) solicitation of comments in connection with Regulatory Notice 14-02 (Notice), proposed amendments to FINRA Rule 4210 for transactions in the TBA Market (Proposed Amendments). BDA is the only Washington, DC-based group representing the interests of middle-market securities dealers and banks focused on the U.S. fixed income markets.

BDA is pleased to have this opportunity to comment on the proposed amendments and encouraged by some of the language contained in FINRA's Notice. As set forth below, however, we believe that the proposed rule will significantly impact market participants, including in particular, middle market dealers; that the requirement to collect maintenance margin is not appropriate or workable in all instances proposed by FINRA; and the multitudes of non-exempt accounts under investment advisors (IAs) bear special consideration. Overall, we are concerned that the rule as currently proposed would negatively affect liquidity in specified pools and unintentionally force a significant portion of business to T+1 settlement, which could be detrimental for reasons we explain later in this letter.

Before discussing the rule proposal, we would like FINRA to take into perspective the balance between reducing risk, and impairing liquidity in a sector of the market principally occupied by end-user customers. When weighing those factors, it makes sense to us for FINRA to consider separating and exempting MBS specified pools, ARM and CMO markets from the actual TBA market at this time**.**

Given the significant impact on market participants and negative effects on liquidity, the risks of addressing MBS specified pool, ARM, and CMO transactions outweigh the benefits. By contrast, the TBA market, based upon TRACE information (average Q1 through Q3 2013 daily trading volume: 225.3 billion dollars), is more than seven times the size of the specified pool, ARM, and CMO markets combined. Taken at the 30,000 foot level, if FINRA were to consider eliminating from the requirements of the rule for all MBS specified pool, ARM, and CMO transactions, FINRA would still capture margining of almost 90% of daily exposure without unintended disruption to the MBS specified pool, ARM, and CMO markets, which will affect retail clients and the subaccounts of investment advisors disproportionately. Additionally, many broker-dealers do not transact business (or are not active) in the actual TBA market because their customers do not require it. As per the FINRA TRACE Fact book, the 50 most active firms account for 99.7% of TBA activity. On the other hand, retail customers and IAs acting on behalf of their subaccounts do not generally transact in TBAs but are very active in the MBS specified pool, ARM, and CMO markets and thus would be hit hardest by the proposed rule.

If the proposal for Rule 4210 will stand, we ask FINRA to consider applying variation/maintenance margin to specified pool, ARM and CMO transactions after T+3 or even, T+5. While this admittedly was not part of the TMPG's recommendations, it would enable customers to match settlements with other investments when simultaneously transacting in other products. For example, equities, corporate and municipal bonds typically settle T+3. If a specified pool, ARM or CMO is swapped for one of those security types, whether buying or selling, it seems unfair for the investor to worry about variation and/or maintenance margin when he or she attempts to match settlement dates. In most cases, the proceeds will net to some degree, and there is little to no systemic risk to these types of transactions. In particular, if one sells T+3 to buy specified pools, one is forced into a potential margining situation affecting cash balances and settlements.

Another benefit of moving to T+3 would come from added liquidity in the marketplace. Generally speaking, many customers of all types will move to T+1 to avoid the margin issue. That being the case, dealers will likely need to fund more positions as a result of their market making for customers. Moving to T+3 will allow them the opportunity to find buyers for a few days before having to worry about margining or capital charges in a relatively low risk business.

We encourage these treatments of CMOs, ARMs and specified pools as they will not detract from FINRA's goals of managing risk, and at the same time, providing this relief avoids potential pitfalls of implementation that would harm liquidity. Given the rule as proposed, however, this letter sets forth below additional proposed solutions for your consideration that could help to mitigate negative impacts.

I. Maintenance Margin Requirements

Collection of maintenance margin from non-exempt accounts is misguided and unprecedented in these markets. Under the existing proposal, FINRA would require a member firm to collect maintenance margin equal to 2% of the market value of the securities subject to the transaction. The BDA opposes the requirement to collect the 2% maintenance margin from non-exempt accounts, and does not believe it translates into a measurable amount of additional protection beyond what more robust internal controls and risk practices can provide.

The requirement would deviate from the TMPG's best practice recommendation for the exchange of bilateral variation margin. Moreover, this additional requirement may put the member firms at a disadvantage in the MBS market. Additionally, we believe the bilateral exchange of variation margin fully covers the member firms for the total exposure on Covered Agency Securities transactions and that the 2% maintenance margin would provide unnecessary additional protection for member firms at the expense of impairing liquidity – effects we address throughout this letter.

Not only is the requirement outside of TMPG's best practice recommendation, but it lacks judicial and regulatory precedent. The collection of the 2% margin exposes counterparties to the credit of the FINRA member firm. Yet there is no case law under the Securities Investor Protection Act that speaks to the status of a counterparty's claim for margin posted to a broker-dealer in a TBA transaction. And, from a regulatory precedent standpoint, while mark to market requirements may be consistent with other regulatory regimes, that is not the case with maintenance margin. In other markets, maintenance margin is required because leverage is used for speculating and trading larger quantities than would be possible if purchases had to be paid for in full upon delivery. If the TBA market is defined to include TBAs, specified pools, ARMs and CMOs, that definition will include many transactions by investors who pay in full on settlement date when the securities are delivered. This relates to our general point that T+3 settlement on all Covered Agency Securities would help, as it would match settlements in equities, corporates and municipals.

Additionally, it is unreasonable to request maintenance margin on a fully paid position. If FINRA insists on the collection of maintenance margin, it should consider allowing maintenance margin to be collected solely on sales to non-exempt counterparties, not on purchases from such customers. It seems unfair to purchase a bond from a counterparty and then ask that counterparty to send a broker-dealer margin to hold until that broker-dealer pays them for their bond.

Maintenance margin is inappropriate for Investment Advisor accounts. In most cases, investment advisors (IAs) have a large percentage of non-exempt accounts, which include retail customers. Given the substantial number of non-exempt accounts under IAs, a significant portion of the market would otherwise be affected by the maintenance margin requirement. In addition, given that these can be buy-and-hold transactions, many non-exempt accounts are currently non-marginable as accounts do not have excess funds available for margining (401k, IRA, etc.). Therefore, it would become impossible for IAs to pull money from accounts to even satisfy a variation margin requirement, never mind a maintenance margin requirement. Based on data from one FINRA member firm, which surveyed over 35 IAs with assets under management ranging from $1 billion to $700 billion, IAs can have upwards of 70% non-exempt accounts and often as many as 100%. The majority of these firms don't have the operational capabilities or the legal right to pull funds from customer accounts for margin purposes. As a result, these end-user customers will be forced to make one of the following poor choices: posting the maintenance margin required, taking their business to a non-FINRA-regulated dealer, or exiting the market altogether in favor of potentially riskier securities.

A capital charge should not be required for maintenance margin. FINRA has proposed requiring the collection of maintenance margin for transactions with non-exempt counterparties when the current deficiency exceeds the minimum transfer amount (MTA). Given that maintenance margin has been included in the MTA, a broker-dealer is unable to collect from a customer until the deficiency reaches the negotiated MTA (as much as $250,000). As such, member firms are required to deduct the total deficiency from tentative net capital, even though maintenance margin is not true exposure. A firm should not have to take a capital charge for any maintenance margin due from the customer since it is not a "true exposure" to the market.

Should maintenance margin be required by FINRA, a tiered approach should be considered on maintenance margin for trades under a certain amount. By setting an MTA of $250,000 and mandating a capital charge for maintenance margin in addition to variation margin, FINRA is building in a guaranteed capital charge for every broker-dealer, a particularly painful one for small-to-mid-sized firms doing business with customers who will never be exposed at that MTA level. While the

BDA understands the expected benefits, the negatives that come from collecting maintenance margin along with the resulting capital charges outweigh the benefits, as it is unlikely that all accounts would default at the same time. Both requirements disproportionately impact small and middle-market dealers that provide an important source of liquidity to the market in the first place. The requirement could result in these broker-dealers leaving the market; the capital charges may simply be that significant. That said, the BDA proposes a tiered approach for the purposes of exempting all trades under a market value of $500,000 from the maintenance margin requirement. This would ensure that small and mid-size broker-dealer firms are not shut out of the MBS market due to aggregate uncollectable margin leading to high capital charges and potentially forcing member firms to cease trading under concentration limit restrictions, or exiting the market altogether.

Capital charges and collection of margin should not be required below a predetermined threshold amount. FINRA could consider allowing broker-dealers to make their own credit risk determinations. FINRA could allow each broker-dealer to assign a threshold amount to each counterparty, below which there should be no capital charges required, up to a maximum of $100,000, while leaving the MTA at $250,000. This would allow small-to-mid-sized firms with limited capital to continue participating and competing in the MBS market without giving large firms an advantage in terms of credit picking. This requirement can be incorporated with the existing proposed requirement for firms to make risk limit determinations and negotiated as part of the Master Securities Forward Transaction Agreement (MSFTA), which allows for provisions of threshold amounts and other margin determinations. FINRA has already set a precedent to allow firms to set credit limits under Rule 15c3-5 without requiring capital charges. Given the proper threshold, the BDA believes the same should apply to counterparty limits for Covered Agency Securities.

II. Risk Limit Determinations

FINRA should allow the use of a statement of net asset value for the purposes of determining risk limits for sub-accounts of an Investment Advisor. FINRA has proposed that members engaged in Covered Agency Security transactions with any counterparty must determine a risk limit to be applied to each such counterparty. When making risk limit determinations for sub-accounts, we ask that FINRA confirm that a statement of net asset value would constitute adequate information for purposes of this analysis. Investment advisors have indicated that in many cases, due to legal reasons, they are unable to release net worth information or actual financial statements for their sub-accounts. Additionally, in many cases, retail accounts may not have financial statements to send. If a statement of net asset value would not be sufficient, it would force member firms to treat potential exempt accounts as non-exempt accounts, forcing the collection of maintenance margin and potentially pushing these customers out of the market, or to non-FINRA members, or out of the MBS markets.

III. Transactions with Exempt & Non-Exempt Counterparties

The five-day close-out requirement timeframe is too short and extensions will be needed. Disputes regarding price differentials on less liquid issues may take longer than five days to resolve. The BDA appreciates FINRA potentially granting an extension of time, but would like FINRA to provide guidance on what circumstances might prompt the granting of an extension.

The concentration limits proposed by FINRA should be raised. FINRA's proposal establishes a new reporting obligation with respect to concentrated credit exposures at five percent of the member's tentative net capital, or for all accounts combined, 25% of the member's tentative net capital. The BDA believes the concentration limits proposed by FINRA should be reconsidered and raised. In addition, maintenance margin should be excluded from the calculation of the concentration limit as it is not a true measure of exposure. We believe that these thresholds are unattainable by most individual customers of member firms as limits of $250,000 are too high to be reached by trading activity with most smaller customer accounts, including sub-accounts of investment advisors. This could cause further operational challenges and potentially, unnecessary stoppage of trading, particularly for smaller firms. For example, if a minimum transfer amount of $250,000 is applied to all of a member firm's accounts, the firm could very quickly reach a concentration limit of 25%, simply because maintenance margin is being included in the capital charge. As such, it is possible to have plenty of excess capital along with normal mark to market exposure and still be forced to stop transacting business. We believe these thresholds are even more burdensome given the reality that a firm could get hit with a capital charge on maintenance margin it may not have been able to collect because the negotiated MTA has not been reached. BDA would therefore recommend that FINRA raise each threshold to 10% and 30% respectively, but also create an allowance such that any uncollected maintenance margin below that threshold is free from capital charges, as previously explained. Lastly, the BDA would ask that FINRA clarify the definition of "commonly controlled accounts." We understand FINRA means to base the definition on "beneficial ownership," but this isn't clear from the proposal.

IV. Impact on Market Participants

Middle market and small broker-dealers bear disproportionate impacts, and liquidity will be affected. Given that many investment advisers are not legally or operationally prepared to deal with variation and maintenance margin, many have said they will consider moving to T+1 trading. Assuming they plan to stay in the market, broker-dealers will be forced to carry more inventories either as a result of customer selling or the need to hold inventory for next day delivery to satisfy customer demand; the bottom line is that the proposal creates a need for additional funding on the part of the dealer. This may disproportionately affect small and medium member firms as they may lack the ability to finance MBS positions for T+1 trading. As such, business will flow to the primary dealers and large firms that have access to financing.

More specifically, unlike other products in the fixed income markets, MBS need to be funded with tri-party lending due to the sheer number of pools that make up a position. Most mid-size and small broker dealers can not readily access this market. Yet many of these mid-size and smaller dealers provide much of the liquidity in specified pools, CMOs and ARMs as the larger/primary dealers avoid trading in smaller quantities and concentrate on actual TBAs. If not self-clearing, broker-dealers will need access to financing these positions through their clearing firms, which will come at a premium. This premium will put them at a competitive disadvantage. At a minimum, applying the proposed rule to T+3 settlement and beyond would help.

While FINRA's proposal favors those dealers with access to tri-party lenders, it should be noted that most of those dealers also clear through MBSCC. This participation in the clearing facility may also discourage business with any counterparty that is not a member of the MBSCC, as a dealer would not want to post variation margin on one side of a bilateral transaction without the ability to collect from MBSCC on the other side. Therefore, the rule unintentionally favors non-membership in the clearing facility. That being said, larger broker-dealers may not wish to do business with non-members of the clearing facility, and thus may not do business with certain players, thereby reducing liquidity in this market. Compounding this effect, small and middle market dealers that provide important liquidity may also exit the market due to the challenges of financing T+1 trading, and having less liquidity themselves.

Compliance timelines and costs are significant. An additional problem for middle market dealers is the sheer cost of compliance and the significant lead time required to adapt. Some may build their own systems to comply, and in that regard, FINRA should bear in mind that firms that have not historically participated in margin trading will be essentially starting from scratch to create processes around a margin call scenario that may occur very rarely. At the same time firms will start from scratch to build solutions and retail customers will likely be extremely slow or reluctant to understand and partake in the margining process, making the compliance timeline a necessarily lengthy one.

Other firms will look to third party solutions. While a number of vendors are offering products designed as full or partial solutions, we have seen pricing that is so significantly burdensome that purchase of the systems would make it uneconomic to continue in trading TBAs. One product being offered by a TMPG member has been quoted to a number of our members as $500 per account. It is not unusual for even a small or middle market firm to service as many as 3,000 accounts when considering subaccounts of investment advisors. Therefore, the costs of such systems could be as high as $15 million per year – clearly a game-changing burden for middle-market dealers. Additionally, it should be noted that the option of clearing through MBSCC is out of reach for most middle market dealers due to its cost, and the process to join has proven lengthy while solving only those issues surrounding the posting of margin requirements with other broker dealers. One member observed costs of nearly $400,000 per year, and waited ten months for approval to join.

Mortgage Bankers will be negatively affected. With respect to mortgage bankers, smaller firms will particularly feel the effects due to their limited resources for margin requirements. A $250,000 threshold will have a direct negative impact on the volume and frequency of transactions with mortgage banker accounts, as well as affect the behavior of mortgage originators as capital is tied-up for margin purposes. FINRA should consider permitting broker-dealers to establish thresholds commensurate with counterparty strength rather than a one-size-fits- all approach. Moreover, rather than track how much mortgage bankers hedge at any given time, the proposed rule would be more workable requiring mortgage bankers or third party aggregators to state periodically that they remain within levels necessary to only hedge loan portfolios. Lastly, should these solutions not be viable, FINRA should provide clarity as to what member firms need to do in order to be in compliance with this portion of the rule, especially given that FINRA does not regulate mortgage bankers and member firms are not in a position to demand proof of trading positions.

The retail market will be negatively affected. It is our belief these rules will have a direct and significant impact on retail customers. Again, as a result of the proposed rule, customers are likely to move to T+1 settlement for these transactions. However, they may exit the market altogether in favor of riskier securities. While on the surface this may seem acceptable, the unintended consequences are significant, as we have explained earlier in this letter, and include lost liquidity and a search for yield in less safe products to replace yield lost in a government security or a security issued by a GSE.

While direct retail participation (when defined as $100,000 original face or less) is minimal in TBA transactions, it is substantial in non-TBA mortgage security transactions, with 43% of all trading taking place with par values of under $100,000. With CMOs, the participation is even higher; more than half, (and certainly more if calculations are based upon remaining balance) of the transactions are for original face of less than $100,000.

Additionally, much of this business is done indirectly by retail, meaning the sub-accounts of asset managers, which invest in mortgage securities on behalf of their clients. Those accounts are designated as either exempt (assets over $45mm) or non-exempt (assets under $45mm). FINRA rules make each of those sub accounts the legal counterparty to a transaction and the proposed margin rule requires the dealer to collect maintenance margin from any non-exempt counterparty. This significantly increases the number of market participants, which include retail accounts that would now be subject to maintenance margin.

Although not a technical requirement from FINRA, to the extent a firm executes MSFTAs with retail customers, there will be yet another hurdle: it will be difficult to attain a signed MSFTA with a retail customer who hasn't traditionally signed one in the past. Although this is not an insurmountable task, it is a challenge to explain such agreements to a retail customer that even though they are highly unlikely to break through the de minimis threshold, because they are entering into a forward settling transaction, they may need to have an MSFTA or customer agreement and post margin on trades that had been straightforward in the past. Additionally, the documentation of such conversations in order to meet the recordkeeping demands of the rule will be so voluminous, time consuming and operationally challenging for firms, it is not out of the realm of possibility that firms and retail customers will want to get out of the business of trading CMOs or MBS for good. Compounding this problem is the potential for a firm to annually request updated information from their customers, even at the subaccount level, in order to ensure accurate limits are in place. FINRA should allow a long time horizon for compliance, given these realities.

V. Conclusion

In conclusion, BDA is concerned that FINRA has proposed a sweeping change that will impair liquidity and disproportionately impact middle-market dealers when a proposed rule with appropriate carve-outs for the collection of margin -- and a more appropriate focus on TBAs -- could capture the vast majority of the risk mitigation that FINRA, and the TMPG, contemplate. We look forward to working with you and are available to answer any follow-up questions you may have. Thank you again for the opportunity to submit these comments.

Sincerely,

Michael Nicholas
Chief Executive Officer
Bond Dealers of America