G.X. Clarke & Co.

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March 28, 2014

Submitted Via Email to pubcom@finra.org

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

Re: Comments on Proposed Amendments to FINRA Rule 4210

Dear Ms. Asquith:

G.X. Clarke & Co. (GXCO, the Company) is submitting this comment letter in response to the Financial Industry Regulatory Authority's (FINRA) Regulatory Notice 14-02 (Notice) and proposed amendments to FINRA Rule 4210 for transactions in the Covered Agency Securities and TBA Market.

G.X. Clarke & Co. is a registered broker-dealer in US Government and Agency securities under the Government Securities Act of 1986 (Rule 402.2). GXCO files a Form G-405 "Report on Finances and Operations of Government Securities Brokers and Dealers."

The Company's trading activities consist primarily of securities trading in connection with U.S. Treasury, U.S. Government agency, and agency mortgage-backed obligations, which consist mainly of mortgage-backed "to be announced" (TBA) securities. The Company only deals with regulated institutional customers.

With regulatory capital of $58.250 million at December 31, 2013 ($50.0MM partnership equity and $8.250MM subordinated liabilities) we believe our comments and issues on proposed changes to Rule 4210 will be insightful in highlighting the major impact the change will have on small member firms such as G.X. Clarke & Co.

G.X. Clarke & Co. participated in the BDA and SIFMA working groups in their response to these proposed Rule 4210 changes. However, we feel it is important to highlight the items that explicitly affect our Company.

The following letter summarizes our thoughts and concerns in response to the proposed amendments to FINRA Rule 4210 for Transactions in the TBA Market (Regulatory Notice 14-02). We agree that safeguards and controls are necessary for the protection of broker/dealers, their clients, and ultimately our industry.

We appreciate this opportunity to reply.

1. **Maintenance Margin Requirement:**

   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.

   G.X. Clarke & Co. opposes the requirement to collect the 2% maintenance margin from non-exempt accounts. The Company does not believe it translates into a measurable amount of additional protection beyond the variation margin requirement as well as what more robust internal controls and risk practices can provide.

   Additionally, this portion of the proposal is a departure from the recommendations of the TMPG and will be operationally challenging for all market participants, especially investment advisors with thousands of sub-accounts. Based on a survey of over 35 investment advisor customers with assets under management ranging from $1 bn to $700 bn, we've realized a majority of the sub-accounts will fall under non-exempt status. That being the case, many of our investment advisor customers have indicated that due to high costs and drain on resources, they would consider either exiting the market or moving to T+1 trading, which as explained later in this letter, would result in lost liquidity in the MBS markets.

   However, should the FINRA proposal stand, the Company presents the following recommendation as a workable solution to the rule change:

   - **Recommendation** – G.X.Clarke & Co. would like to recommend a tiered approach to applying maintenance margin based on the "net" of open buys and sells with a non-exempt counterparty, as follows:
     - Net buy / sell of $500,000 or less in market value ($10,000 maximum margin) would be excluded
     - Net buy / sell greater than $500,000 in market value would require collection of 2% maintenance margin.

2. **Capital Charges:**

   The $250,000 minimum transfer amount (MTA) poses particular challenges to G.X. Clarke & Co. and other medium and small firms. We view the $250,000 MTA as a "forced" capital charge to all firms. As $250k MTAs would be applied to each account, margin would be uncollectible the majority of the time, which may have the potential to

restrict business, especially when aggregated across the sub-accounts of investment advisors, and includes maintenance margin, which is not even true exposure.

While the Rule allows the MTA to be negotiated to a lower amount, this may turn out to be anti-competitive. A firm would not likely agree to a lower MTA with GXCO when they can trade at a higher MTA somewhere else in order to engage in fewer transfers of margin.

- **Recommendation** – G.X.Clarke & Co. would like to recommend a tiered approach to applying Capital Charges on MTA exposure under the $250k maximum:
  - Total deficiency of less than $100,000 would be excluded or 5% capital charge consistent with current Rule 402.2.
  - Total deficiency between $100,000 and $250,000; 10% capital charge.

G.X. Clarke & Co.'s basis for recommending the above changes to this proposal is focused around the "counterparty exposure haircut" included in FOG Rule 402.2. The rule calls this exposure a haircut due to its place in the calculation. In 15c3-1 most exposure charges are treated as a capital charge.

- "The total "counterparty exposure haircut" equals the sum of the counterparty exposure haircuts taken for all counterparties except a Federal Reserve Bank, of the government securities broker or dealer. The "counterparty exposure haircut" equals the product of a counterparty exposure haircut factor of 5 percent and the net credit exposure to a single counterparty not in excess of 15 percent of the government securities broker's or dealer's liquid capital.
  - For GXCO the majority of its counterparty exposure comprises deficits on open trades and exposure on tri-party repo margin.

3. **Documentation: 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.**

One of the definitions of an "exempt account" per FINRA Rule 4210(a)(13) is as follows:

- makes available to the member such current information regarding such person's ownership, business, operations and financial condition (including such person's current audited statement of financial condition, statement of income and statement of changes in stockholder's equity or comparable financial reports), as reasonably believed by the member to be accurate, sufficient for the purposes of performing a risk analysis in respect of such person.

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. 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, while at the same time increasing capital charges for the member firm.

- **Recommendation** – G.X.Clarke & Co. would like to recommend a statement of net asset value plus W-9 (will show legal standing) as sufficient information to validate the sub-account and set risk limits. The requirement is to obtain sufficient information in order to qualify a client as an exempt account and set risk limits, which does not necessarily have to include the client's financial statements.

4. **Eligible Collateral:** G.X. Clarke & Co. believes that the collateral eligible for margin should be negotiated between the parties in their MSFTA agreement, or otherwise, as an MSFTA is not required. This issue should not be determined by regulation. Case in point, as a government broker-dealer, GXCO is only permitted to transact in US Government and Agency securities.

5. **Effective Date:** G.X. Clarke & Co. agrees and supports both SIFMA and BDA that an implementation period of eighteen months after approval would be appropriate. The vast majority of our accounts are not prepared for margining. All the complexities from legal, compliance, and IT will take at least that amount of time.

6. **Unintended Consequences - Middle market and small broker-dealers will be most affected and will bear disproportionate impacts in funding, liquidity, trading, and costs.**

   Funding and Liquidity - 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. 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 may flow to the primary dealers and firms that have access to financing. Assuming they plan to stay in the market, smaller 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. This creates the need for additional funding on the part of the dealer burdening the small and mid-size broker-dealers disproportionately.

   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. The larger/primary dealers avoid trading in smaller quantities and concentrate on actual TBAs.

If not self-clearing with access to tri-party funding, these smaller broker-dealers will need access to financing these positions through their clearing firms, which will come at a premium. This additional cost will put them at a competitive disadvantage.

- **Recommendation** – G.X. Clarke & Co. proposes, at a minimum, T+3 settlements for all MBS Agency products, except TBAs. Small and medium-sized broker-dealers currently use delayed settlement to find liquidity. Should many customers move to T+1, these broker-dealers may need to exit the market. T+3 will provide better liquidity in the MBS market.

Trading - 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 the case, larger broker-dealers may not wish to do business with non-members in the clearing facility. Should that happen, small and middle market dealers that provide important liquidity to end users may exit the market due to the challenges of lost liquidity from the larger dealers

Cost - An additional problem for middle market dealers is the sheer cost of compliance. Some may build their own systems to comply, but others 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 trading in the TBA markets as defined.

One product being offered by a TMPG member has been quoted to a number of broker-dealers as $500 per account, per month. It is not unusual for even a small or middle market firm to service as many as 3,000 accounts when considering the 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 small and middle-market dealers.

- At G.X. Clarke & Co. the cost will be significant. It will, at a minimum, require the addition of 1 to 2 full-time employees to a current department staffed with 5 employees. The Company will be required to add resources for margin and cover additional documentation requirements within the credit department.

- Additionally, technology resources will be required to build and support additional margin system requirements.

7. **G.X. Clarke & Co – Regulatory Capital - FOG.**

G.X. Clarke & Co. is a registered broker-dealer under the Government Securities Act of 1986 and files under Form G-405 "Report on Finances and Operations of Government Securities Brokers and Dealers" per 402.2 (Re: FOG).

With these proposed rules the possibility of duplicative capital charges may occur due to an overlapping of rules. Per the rule, the Company currently calculates capital requirements for registered government securities brokers and dealers and takes a 5% charge on counterparty exposure. This haircut charge was summarized in Section 3.

G.X. Clarke & Co. will need interpretative support from FINRA to ensure that these proposed rules do not duplicate capital charges or haircuts due to an overlapping of rules. This may result in an anti-completive situation if the Company is forced to take higher charges than a broker-dealer subject to Rule 15c3-1.

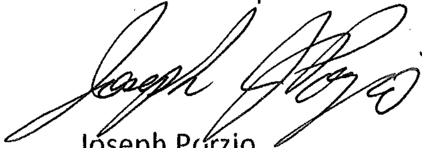
Summary – G. X. Clarke & Co., as a small institutional broker-dealer, is concerned that these sweeping changes will impair liquidity and disproportionately impact small and medium size firms.

G.X. Clarke & Co. attends various FINRA and industry association conferences. We have heard many times from FINRA representatives that the ultimate goal is for rules to be "fair and equitable to ALL firms". We believe the rules as currently proposed do not achieve this goal.

Thank you for allowing us the opportunity to comment on this proposal. Please feel free to contact us with any questions about the content of this letter.

Sincerely,

Marc S. Porter
Managing Partner
Co-Chief Compliance Officer



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