March 28, 2014

Submitted via Email to pubcom@finra.org
Marcia E. Asquith
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, DC 20006-1506

Re: Proposed Amendments to FINRA Rule 4210 for TBA Transactions

Dear Ms. Asquith:

The Asset Management Group ("**AMG**") [1] of the Securities Industry and Financial Markets Association ("**SIFMA**") is pleased to submit this letter to the Financial Industry Regulatory Authority ("**FINRA**") in response to FINRA's request for comment on its proposed amendments to FINRA Rule 4210 which would establish margin requirements for transactions in "Covered Agency Securities," which include transactions in the "To-Be-Announced" ("**TBA**") market[2] (the "**Proposed Amendments**").

AMG generally supports the aim of the Proposed Amendments to mitigate the counterparty credit risk borne by participants in the TBA market and reduce the potential for systemic risk. However, we have the following comments on the Proposed Amendments, each as discussed further below: (i) the maintenance margin requirement should be eliminated; (ii) "liquidating action" should not be mandated by the Proposed Amendments; (iii) "commonly controlled accounts" should not include accounts by virtue of being managed by the same asset manager; (iv) the parties to Covered Agency Securities should be free to negotiate the settlement period for posting margin up to a three-day period after a margin call; (v) certain technical changes should be made to the Proposed Amendments; and (vi) the compliance date for the Proposed Amendments should be 18 months following effectiveness.

[1] AMG's members represent U.S. asset management firms whose combined assets under management exceed $20 trillion. The clients of AMG member firms include, among others, registered investment companies, ERISA plans and state and local government pension funds, many of whom invest in commodity futures, options, and swaps as part of their respective investment strategies.

[2] The TBA market includes transactions in adjustable rate mortgages ("**ARMs**"), Specified Pool Transactions and Collateralized Mortgage Obligations ("**CMOs**") with forward settlement dates.

I. The Maintenance Margin Requirement Should Be Eliminated

AMG feels strongly that the requirement for maintenance margin should be eliminated from the Proposed Amendments.[3] The issue is not a new one. In developing its Best Practices for Treasury, Agency Debt and Agency Mortgage-Backed Securities Markets (the "**TMPG Best Practices**"),[4] the Treasury Market Practices Group (the "**TMPG**") carefully considered – then rejected – the idea of imposing initial (or "maintenance") margin in the TBA Market. The TMPG Best Practices currently contains no such requirement. AMG generally supports the TMPG Best Practices and believes that FINRA rules should generally be consistent with them. For FINRA to require Members to collect maintenance margin from non-exempt customers would force those customers to transact with non-Member banks and severely fragment the market.[5]

AMG believes that there is no compelling reason to impose a maintenance margin requirement in the TBA market. The purpose of maintenance margin is to protect a party from potential future exposure to changes in the marked-to-market value of securities during the "liquidation period" in which the position is being closed out or replaced, following a default by its counterparty. The amount of maintenance margin reflects an estimate of this potential future exposure and depends in large part on the expected duration of the liquidation period. The greater the liquidity of an instrument, the shorter the liquidation period is likely to be. The TBA market is extremely liquid. First, the aggregate size of the market is extremely large.[6] Second, the TBA market is limited to securities sponsored by government-sponsored agencies ("**agency MBS**") which benefit from agency guarantees of payment of principal and interest on the underlying mortgages. Third, agency MBS are subject to either an explicit or implicit government credit guarantee. Fourth, transactions in the TBA market are highly homogenous. Since the identity of the mortgages in the agency MBS to be delivered at settlement is not specified on the trade date, TBAs trade solely on the basis of six general parameters of the securities to be delivered (issuer, maturity, coupon, price, par amount, and settlement date). Finally, TBAs trade on a "cheapest to deliver" basis, making settlement easier and increasing liquidity. With such vast liquidity, TBA market participants should be able to liquidate and replace defaulted positions easily and quickly, with minimal risk of exposure to changes in the

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[3] The Proposed Amendments provide that for bilateral transactions with non-exempt accounts, FINRA members ("**Members**") must collect, in addition to variation margin, maintenance margin equal to two percent (2%) of the market value of the securities subject to the transaction. If sufficient margin is not collected, the Member will be required to deduct the uncollected amount from the Member's net capital at the close of business following the business day on which the deficiency was created. Additionally, if the deficiency in margin is not satisfied within five business days, the Member must take liquidating action, unless FINRA grants the Member an extension.

[4] Treasury Markets Practice Group, Best Practices for Treasury, Agency Debt, and Agency Mortgage-Backed Securities Markets, Revised May 2013 (*available at* www.newyorkfed.org/tmpg).

[5] As discussed further in Section II herein, the Proposed Amendments require a net capital deduction and the obligation to take liquidating action for both exempt and non-exempt accounts.

[6] "The TBA market is the most liquid, and consequently the most important secondary market for mortgage loans. . . . [A]n average of $246 billion of agency MBS was traded each day in March 2013 . . . ." SIFMA, TBA Market Fact Sheet: The TBA Market, 2013 (av*ailable at* http://www.sifma.org/).

marked-to-market value of the securities that are the subject of the transaction. As a result, there is no need for maintenance margin in the TBA market.

The proposed maintenance margin requirements will adversely affect the market. Because the requirements are only applicable to non-exempt accounts, the costs would be borne by smaller market participants. In addition, asset managers may only be able to deliver information relating to assets under their management, not the full financials for a separately managed account client. In such a scenario, clients who would otherwise be exempt accounts might nonetheless be required to post maintenance margin because asset managers will be unable to provide dealers with sufficient financial information to take them out of the scope of the proposed requirements. As a result, such smaller clients and separately managed account clients are likely to be driven out of this investment space or pushed to transact with non-Member banks, causing consolidation and reduced liquidity. Such reduced liquidity will increase hedging costs for mortgage originators and the cost of mortgages for homeowners.[7]

Maintenance margin will also introduce new credit exposures and market risks. By posting maintenance margin to protect a Member against its counterparty's default, the counterparty risks losing this amount if the Member defaults. The maintenance margin requirement also decreases liquidity by freezing large amounts of high quality collateral, which could increase systemic risk. In addition, counterparties may have to borrow to meet maintenance margin requirements, which would shift risk into the funding markets.

Finally, the one-size-fits-all requirement of two percent mandatory maintenance margin on all non-exempt accounts is too blunt an instrument; instead the parties closest to the transaction are best positioned to determine the need for, and amount of, maintenance margin in each transaction. The Proposed Amendments already require Members to assign a risk limit determination to "any counterparty" with which it will engage in relevant transactions. AMG believes that this risk assessment could be more properly used as a tool to determine the counterparties from whom a Member would require maintenance margin.

II. "Liquidating Action" Should Not Be Mandated by the Proposed Amendments

The Proposed Amendments provide that if a counterparty does not pay required maintenance margin or a marked-to-market loss, a Member must deduct from its net capital any uncollected margin at the close of business following the business day that the margin collection deficiency was created. Any margin deficiencies not satisfied within five business days from when the deficiency was created require the Member to promptly take "liquidating action," unless granted an extension of time by FINRA.[8] We believe that this requirement is too heavy-handed an approach, and we suggest that FINRA align its position with that of TMPG which

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[7] See Vickery & Wright, TBA Trading and Liquidity in the Agency MBS Market, Federal Reserve Bank of New York Staff Report no. 468 (Aug 2010) (concluding that the TBA trading convention "significantly improves agency MBS liquidity, leading to lower borrowing costs for households.").

[8] FINRA Rule 4210(e)(2)(H)(ii)(e).

considered and rejected mandating liquidating action after a failure to post margin. Accordingly, no such requirement appears in the TMPG Best Practices.

Whether to liquidate trading positions in the face of a counterparty failure to post margin is a business decision and should not be mandated by rulemaking. In standard collateral documentation, following a default and any applicable cure period, the non-defaulting party typically has the right – but not the obligation – to liquidate, close out and set off. Depending on the nature of the relationship with the counterparty, the reason for the default, the likelihood of curing the default, the market for the collateral, and the size of the positions, there may be reasons for the non-defaulting party to refrain from or delay liquidating positions. For example, the template Master Securities Forward Transaction Agreement ("**MSFTA**") published by SIFMA defines "Event of Default" to include any failure by a party to meet its margin obligations, but permits the parties to negotiate whether to include a cure period and how long that period should be. Following an Event of Default, the "non-defaulting party may, at its option, declare an Event of Default to have occurred" and only then, liquidate and close out all transactions under the MSFTA. Such contractual discretion is designed to allow the parties to tailor their arrangements to the particular circumstances and provide them with flexibility on when (or whether) to exercise any available contractual remedies.

In contrast, the Proposed Amendments would impose inflexible and overly aggressive, one-size-fits-all time frames. In the case of a legitimate dispute (for example, a dispute over calculation of exposure), the five-business day period is unlikely to allow sufficient time for resolution before the close-out period has run.[9] Nor do the required time frames for posting of margin account for cross-border transactions involving different time zones. Finally, mandating liquidating actions may drive market participants to transact with counterparties that are not subject to such restrictions, such as banks, thereby fragmenting the market and diminishing the competitiveness of FINRA Members in the marketplace. In sum, the parties should be free to negotiate their own provisions relating to the posting of margin, liquidation, and the related time frames.

III. "Commonly Controlled Accounts" Should Not Include Accounts by Virtue of Being Managed by the Same Asset Manager

Under Section (e)(2)(I)(ii)(a) of the Proposed Amendments, Members would be required to provide written notification to FINRA and would be prohibited from entering into any new transactions with exempt accounts that would result in increased credit exposure if net capital deductions resulting from deficiencies in collecting margin or marked-to-market losses over a five-business day period exceed five percent of the Member's tentative net capital for a single account or group of ***commonly controlled accounts***, or 25 percent of the Member's tentative net capital for all such accounts combined.

[9] We request that, at a minimum, FINRA clarify this provision by providing that in the event of a legitimate dispute, the five-business day period does not apply.

The term, "commonly controlled accounts," is used in Section (e)(2)(I)(ii)(a) but undefined in Rule 4210. FINRA Rule 0160(a) provides that terms not defined in FINRA rules are to be defined as set forth in the FINRA By-Laws, if a definition is provided therein. Article 1(h) of the FINRA By-Laws defines the word "controlling" to mean "the possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting stock, by contract or otherwise."[10]

It is our understanding that this definition excludes accounts that are related by virtue of being managed by the same asset manager, and we request that the Proposed Amendments clarify that this is the case. Accounts do not share the same credit profile simply because they share an asset manager and aggregating the exposure for such accounts is not indicative of greater credit risk with respect to any individual account. Further, because there is no recourse among the various accounts of a single investment manager, grouping such accounts together for the purposes of determining credit exposure will not mitigate risk.

IV. The Parties to Covered Agency Security Transactions Should Be Free to Negotiate the Settlement Period for Posting Margin Up to a Three-day Period After the Margin Call

The time allowed under the Proposed Amendments for parties to post margin is insufficient given differences in international time zones and holidays and the potential for operational delays. Under the Proposed Amendments, when a counterparty does not pay the required maintenance margin or the Member's marked-to-market loss, the Member must deduct from its net capital any uncollected margin at the end of the day following the business day of the creation of the deficiency. This timeline effectively requires margin to be posted the day after a margin call. Instead, counterparties should be free to negotiate their own settlement timelines, subject to a three-day maximum period, to accommodate the specific circumstances of individual transactions.

A margin settlement period of only a single day after the margin call fails to account for the different circumstances presented by differently situated market participants. Members may be transacting with counterparties located in different time zones, which would create inconsistencies in time frames for posting margin. Non-domestic counterparties may also have different holiday schedules, leading to complications in determining the business day on which margin must be posted and requiring the extension of the margin settlement period. Additionally, clients whose assets are held by custodians create notable operational delays. The significant lag time in dealing with customers who must operate through custodians (for example, in offshore transactions or transactions in non-domestic currencies) makes such a short margin settlement period infeasible. Moreover, when transacting with counterparties using non-domestic currencies, the counterparty must have sufficient time to exchange the foreign currency for use as collateral in domestic currency. This currency conversion will be done on spot foreign exchange markets and will generally introduce an additional two-day settlement cycle. At best, such a counterparty may execute the foreign exchange transaction – at an increased cost – on a one-day settlement cycle, but this will still introduce an additional day into the margin settlement

[10] It also contains a rebuttable presumption that ownership of 20% or more of the voting stock of an entity constitutes control, along with certain exceptions.

period. Moving to a settlement period of one day after the margin call would change longstanding practices for certain asset managers across portions of their client base, requiring costly and burdensome systems and operational changes for those asset managers. Thus, we propose that margin settlement be extended to three days following the call for margin with an allowance for parties to negotiate shorter margin settlement periods for individual transactions.

V. Certain Technical Changes Should Be Made to the Proposed Amendments

A. Scope. As previously indicated, we generally support the TMPG Best Practices. Nevertheless, there are some scoping issues that we think should be addressed. For example, we agree with the Proposed Amendment's exclusion of "central banks" from the margin requirements under Rule 4210. Section (e)(2)(H)(ii)(a) of the Proposed Amendments makes clear that transactions in Covered Agency Securities with a counterparty that is a "central bank" would not be subject to margin requirements under Rule 4210. Footnote 23 of Regulatory Notice 14-02 states that that "FINRA would interpret 'central bank' to include, in addition to government central banks and central banking authorities, sovereigns, multilateral development banks and the Bank for International Settlements."[11] AMG requests that FINRA codify this interpretation directly into Rule 4210. In addition, we believe that sovereigns typically make investments through specialized investment vehicles which they guarantee. Such sovereign wealth funds present credit profiles that are substantially similar to those of the sovereign itself. Accordingly, AMG requests that sovereign wealth funds be explicitly excluded from the purview of Rule 4210.

Finally, despite our general agreement with the TMPG Best Practices, we have previously expressed our objection to including securities with T+2 or T+3 settlement cycles within the scope of their recommendations. Some of our members maintain this objection as they believe it would unnecessarily impede liquidity and do little to reduce credit exposure or mitigate systemic risk, and they believe the margin requirements should match the standard settlement cycles of the spot market for those securities (i.e., from greater than T+1 to greater than T+3). We continue to engage in discussions with the TMPG on this subject. Recognizing the need to have consistency in the regulation of the TBA market and to avoid market fragmentation, we recommend that if, and to the extent that, either the TMPG or FINRA modifies the scope of inclusion of these instruments, then the organizations work together to harmonize their provisions.

B. Bilateral Variation Margin Should Be Permissible. AMG believes that the Proposed Amendments should clarify that the counterparties may agree to adopt bilateral variation margin. Under the current version of the Proposed Amendments, a Member must collect any mark-to-market loss in excess of the *de minimis* transfer amount within one business day, or deduct the deficiency from the Member's net capital until such deficiency is satisfied. Although Regulatory Notice 14-02[12] implies that this variation margin may be bilateral,[13] the text of the Proposed

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[11] Regulatory Notice 14-02, p. 11 n. 23.

[12] FINRA Regulatory Notice 14-02, Margin Requirements: FINRA Requests Comment on Proposed Amendments to FINRA Rule 4210 for Transactions in the TBA Market, Jan. 2014.

Amendment indicates that, unless the transaction is between two Members, variation margin is applied only one way. Bilateral variation margining should be supported as a means to mitigate the credit risk that non-Member market participants will have with respect to their Member counterparties and may help with the reduction of systemic risk. This is consistent with the approach in the TMPG Best Practices, which states that in order to help *both* parties mitigate counterparty risk, "two-way variation margin should be exchanged on a regular basis."[14]

C. Omnibus Accounts. Supplementary Material .04 to the Proposed Amendments says that the determination of whether an account qualifies as an exempt account shall be made based on the beneficial owner of the account, and subaccounts managed by an investment adviser, where the beneficial owner is other than the investment adviser, shall be margined individually. To the extent that maintenance margin is required under the final version of the Rule, AMG would like to confirm that this principle applies only where the investment adviser manages multiple subaccounts. Conversely, where an investment adviser manages a single omnibus account and has agreed that the account may be treated as the account of a single principal, the determination of exempt account status should be made based on the status of the entire account and that no information about the underlying beneficial owners needs to be obtained by the Member.

VI. The Compliance Date for the Proposed Amendments Should Be 18 Months Following Effectiveness

The Proposed Amendments should have a compliance date that is at least 18 months following the date of their effectiveness. This time period would allow Members and non-Members to change necessary systems and documentation, as well as educate clients, so as to be able to comply with Rule 4210. The market's experience with the TMPG Best Practices is instructive. Due to the very broad participation in the market for Covered Agency Securities, despite diligent efforts, banks were unable to negotiate and execute MSFTA agreements with significant numbers of their clients within the period established by the TMPG. An equally long period of time should be expected to implement the Proposed Amendments.

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[13] *See id.* at 4 ("However, such transactions must be marked to the market daily and the Member must collect any loss resulting from such marking to market (*i.e.*, Members must collect variation margin, which is consistent with the approach taken by the TMPG best practices and ***includes the posting of margin between all counterparties***, including broker-dealers)) (emphasis added).

[14] TMPG Best Practices, p. 3.

The AMG appreciates the opportunity to comment on the Proposed Amendments. Should you have any questions regarding our comments, please do not hesitate to call Tim Cameron at 212-313-1389, Matt Nevins at 212-313-1176 or Dan Budofsky of Bingham McCutchen LLP at 212-705-7546.

Sincerely,

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