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March 27, 2014

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

Re: Regulatory Notice 14-05
Proposed Amendments to FINRA Rule 4210 for Transactions in the TBA Market

Dear Ms. Asquith:

Brevan Howard Investment Products Ltd. ("**Brevan Howard**")[1] appreciates the opportunity to comment on Financial Industry Regulatory Authority, Inc. ("**FINRA**") Regulatory Notice 14-05 (the "**Regulatory Notice**") proposing to establish margin requirements under FINRA Rule 4210 (the "**Proposed Rules**") for FINRA members transacting in To Be Announced transactions and certain other mortgage-backed securities instruments (collectively, "**TBAs**").

We generally support the Proposed Rules and FINRA's much-needed focus on the regulation of the TBA market. However, we believe that the Proposed Rules must be considered in light of the legal status of TBAs, which distinguishes them from other securities products that FINRA members transact. Further, we believe that the margining of TBA transactions should be generally consistent with the approach being adopted globally for the margining of OTC derivative transactions. As such, we have concerns regarding the manner in which customer margin will be protected if the Proposed Rules are adopted[2] and the one-way flow of variation margin contained in the Proposed Rules.

In addition, we believe that FINRA's proposal should be a first step in a broader re-evaluation of the level of regulation of, and particularly the protections afforded to

[1] Brevan Howard is a global alternative asset manager that manages institutional assets in excess of $38 billion across a number of diversified strategies. From time to time, funds managed by Brevan Howard engage in TBAs and related transactions with, and clear TBA transactions through, FINRA members.

[2] As discussed below, Brevan Howard recognizes that there is a lack of certainty regarding the status of counterparties to TBAs as "customers," but uses "customers" in this letter to refer to those counterparties entering into TBA transactions with or through FINRA member firms.

Brevan Howard Investment Products Limited St Helier (Jersey) Geneva Branch is a branch of Brevan Howard Investment Products Limited which is regulated by the Jersey Financial Services Commission.

counterparties in, the TBA market. In particular, FINRA should expand the Proposed Rules to set forth requirements for members' handling of customer margin for cleared TBAs.

I. Status of TBAs and TBA Customers in Insolvency

In general, the purpose of requiring a party ("**Counterparty A**") to post margin to its counterparty ("**Counterparty B**") is to protect Counterparty B from losses in the event that Counterparty A defaults on its obligations. At the same time, however, by posting margin, Counterparty A becomes exposed to the risk that Counterparty B defaults, leaving Counterparty A to seek the return of its margin from an insolvent firm. Because margin requirements, the handling of margin, and insolvency are inherently connected, it is essential that any proposed margin requirements be considered in light of the specific insolvency regime that would apply.

FINRA member broker-dealers are generally subject to the Securities Investor Protection Act of 1970 ("**SIPA**") and, in the case of their insolvency, would be subject to liquidation by the Securities Investor Protection Corporation ("**SIPC**"). SIPA protects customers and customer assets, including customer margin held by a failed broker-dealer, in a number of ways. Among other things, customers of the failed firm are entitled to share ratably in all customer property which the firm holds. This significantly limits potential customer losses, as Rule 15c3-3 under the Securities Exchange Act of 1934 (the "**Exchange Act**") requires broker-dealers to maintain possession or control of fully paid and excess margin securities as well as to segregate an amount of cash generally corresponding to its liabilities to customers—including customer margin. These assets would be customer property available for pro rata distribution to customers.

However, it is not at all clear that TBA customers would be entitled to any of these protections. In fact, the one court that has considered the question agreed with SIPC and found that TBAs were not securities. Therefore, customers that entered into TBA transactions with a failed broker-dealer were not "customers" entitled to any protections under SIPA.[3] While Brevan Howard does not agree with that court's conclusion, or believe that other courts should follow it, because it is the only judicial authority on point, the working presumption must be that TBA customers are not customers for SIPA purposes.[4]

The exclusion of TBA customers from SIPA customer status has critical implications for the counterparty credit risk that a broker-dealer presents when dealing in

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[3] *See* Memorandum Decision Confirming the Trustee's Determination of Claims Relating to TBA Contracts, In re Lehman Brothers Inc., 462 B.R. 53 (Bankr. S.D.N.Y. 2011).

[4] Similarly, a SIPC task force has recommended that, consistent with this judicial opinion, claims arising out of TBAs be treated as general creditor claims. *See* Report and Recommendations of the SIPC Modernization Task Force (Feb. 2012), *available at* http://www.sipc.org/Content/media/news-releases/Final%20Report%202012.pdf.

TBAs. Consider the potential customer losses in the event that a broker-dealer fails with outstanding unsettled TBAs in the following scenarios:

1. A customer enters into a TBA with its broker-dealer, agreeing to pay $10 million at settlement date in return for securities with certain features. The broker-dealer requires that the customer post $200,000 collateral to protect the broker-dealer from the risk that the securities decline in value before settlement and the customer fails to pay. There has been no change in the value of the securities, but the broker-dealer fails and enters SIPA liquidation. The customer has a claim for the return of its $200,000 collateral.

2. A customer enters into a TBA with its broker-dealer, agreeing to pay $10 million at settlement date in return for securities with certain features. Before settlement, the value of securities with those features increases to $10.5 million, but the broker-dealer fails and enters SIPA liquidation. The customer has a claim for its $500,000 when the broker-dealer fails to deliver the securities.

In each situation, because the TBA customer is not a customer under SIPA, their claim would be relegated to that of a general unsecured creditor with no priority over other creditors.

II. TBA Customer Margin Must be Protected

The Proposed Rules would require FINRA members to collect 2% initial[5] and maintenance margin from customers that are not "exempt accounts".[6] Brevan Howard is concerned that customers posting maintenance margin to FINRA members, as FINRA proposes to require, would be entitled to no protection of that margin in the case of the FINRA member's failure. FINRA should revise its Proposed Rules to provide for adequate protection of the assets of TBA customers.

Under Rule 15c3-3, a broker-dealer receiving a customer margin from a *securities* customer would generally be required to include the margin in its reserve account formula, effectively causing it to segregate an equivalent amount of cash into its special reserve account for the exclusive benefit of customers. This prevents the broker-dealer from using the customer margin for its own business. However, for the same reasons that a TBA customer may be not be a "customer" for SIPA purposes, it may not be a "customer" for purposes of Rule 15c3-3—meaning that a broker-dealer receiving margin from a TBA customer would be able to use it for its own business purposes. In fact, even

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[5] While the Proposed Rules only reference maintenance margin, Rule 4210 requires that initial margin be obtained in at least the amount of any required maintenance margin.

[6] "Exempt accounts" generally includes registered broker-dealers, banks, savings associations, insurance companies, investment companies, states or subdivisions, pension plans, and persons meeting specified net worth requirements and other conditions. We note that private investment funds managed by Brevan Howard would not generally appear to qualify as exempt accounts.

if the broker-dealer treats a TBA customer as a "customer" for the purposes of Rule 15c3-3 and includes the TBA customer margin in its reserve account formula, this would not serve to provide the TBA customer with any protection. Ultimately, if a TBA customer is not a "customer" for SIPA purposes, it would not have a customer claim in a SIPA liquidation. Any margin it posted that the broker-dealer considered in calculating its special reserve account deposit would just add to the customer property to be shared among *securities* customers—out of reach of the TBA customer. The TBA customer would still be a general unsecured creditor in any attempt to recoup its margin.

Brevan Howard believes that FINRA's proposal to require that its members collect maintenance margin from TBA customers must be enhanced to address the protection of that margin, rather than treating it in the same manner that a broker-dealer's securities customers' margin is treated. Absent the adoption of the Proposed Rules, broker-dealers are free to negotiate with their TBA customers to contractually require collateral, and TBA customers may, in turn, negotiate for adequate protection of that collateral. FINRA should not impose regulatory margin requirements that would effectively force TBA customers to become unsecured creditors when seeking the return of their own margin.

Consistent with proposed international regulatory standards for margin on OTC derivatives transactions,[7] and, in fact, Congress' Exchange Act directive for margin posted to security-based swap dealers for uncleared securities-based swaps,[8] FINRA should require adequate protection be provided for maintenance margin posted to members for TBA transactions. Specifically, FINRA should require that member firms hold TBA customer maintenance margin through a tri-party custodial arrangement. Under such an arrangement, the margin would be held by an independent custodian and recognized as the property of the TBA customer posting it, but pledged and accessible to the broker-dealer in the event of the TBA customer's default. This arrangement would protect the TBA customer's maintenance margin in the event of the broker-dealer's insolvency from becoming part of the broker-dealer's general estate and subject to the claims of general creditors, allowing for its prompt return to the posting TBA customer. At the same time, the broker-dealer would have the benefit of the margin protection, as it is held away from the TBA customers, and pledged and available in the case of the TBA customer's default.

We acknowledge that, other than for registered investment company customers, FINRA generally does not permit broker-dealers to hold customer margin under tri-party

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[7] *See, e.g.*, Basel-IOSCO, Margin Requirements for Non-Centrally Cleared Derivatives (Sept. 2013) (the "**Basel-IOSCO Margin Framework**") ("collected margin must be subject to arrangements that fully protect the posting party to the extent possible under applicable law in the event that the collecting party enters bankruptcy.").

[8] Exchange Act §3E(f) (requiring security-based swap dealers, at the request of a counterparty, to hold the counterparty's margin in a segregated account).

custody arrangements. In fact, were a broker-dealer to hold customer margin under such an arrangement, the SEC would generally require the broker-dealer to take a net capital charge as a result of an account being under-margined.[9] This may be sensible for *securities* customer margin, given the structure of Rule 15c3-3 and SIPA and the protections they afford. However, as TBA customer margin would not receive Rule 15c3-3 or SIPA protections, a tri-party custodial arrangement is an appropriate alternative protection scheme that protects both the broker-dealer and the TBA customer while not impacting the rights of securities customers.

III. Two-Way Exchange of Variation Margin Should be Required

The Proposed Rules would require each FINRA member to collect any mark-to-market loss (*i.e.*, variation margin) from each TBA counterparty.[10] However, the proposal does not appear to require that FINRA members *post* variation margin to their customer when the FINRA member would have a mark-to-market loss (and the customer a mark-to-market gain), unless the counterparty is also a broker-dealer.[11] This gap leaves customers at risk of losses of any mark-to-market gain if their broker-dealer were to become insolvent. Further, it could cause a strain on a customer's liquidity where that customer has hedged its position with instruments subject to bilateral margining. FINRA should therefore require that both customers and broker-dealers post variation margin.

In the Regulatory Notice, FINRA cited approvingly the best practices recommendations of the Treasury Market Practices Group[12] (the "**TMPG Best Practices**"), but noted that the TMPG Best Practices are only recommendations. As such, FINRA determined to propose requirements that would apply to all its members. While FINRA is not bound by the TMPG Best Practices, the Proposed Rules are conspicuously inconsistent with both the TMPG Best Practices and international regulatory standards for margining of uncleared OTC derivatives. Specifically, the TMPG Best Practices states that, in order "[t]o help both parties mitigate counterparty risk owing to market value changes, two-way variation margin should be exchanged on a regular basis." The TMPG has explained that it recommends two-way exchange of variation margin because:

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[9] *See, e.g.*, Exchange Act Release No. 68071 at 113–14 (Oct. 18, 2012) (proposing margin rules security-based swap dealers and comparing rules for broker-dealers).

[10] The Proposed Rules only require that the margin be collected if the amount to be received exceeds $250,000, referred to as a *de minimis* threshold. However, because a FINRA member that elects not to require margin below $250,000 be transferred would be required to deduct that amount from its net capital, we expect that firms would generally require margin even below the *de minimis* threshold.

[11] *See* Proposed Rule 4210(e)(2)(H)(iii)(d) (requiring each member to collect any mark-to-market loss from an exempt counterparty, which includes another member). *See also* Regulatory Notice at note 18 (discussing the net capital impact of broker-dealers posting variation margin).

[12] *See* Treasury Market Practices Group, Best Practices for Treasury, Agency Debt, and Agency Mortgage-Backed Securities Markets (Nov. 2012), *available at* http://www.newyorkfed.org/tmpg/marginambs.pdf.

> When both parties are subject to counterparty credit risk, exchanging variation margin two ways will help protect both parties if the market value of the transaction in deliverable securities fluctuates. Moreover, widespread two-way margining should increase the resiliency of the agency MBS market more broadly, helping to prevent rapid and potentially destabilizing price volatility.[13]

We agree. In light of the status of TBA customers in a broker-dealer insolvency, TBA customers are fully exposed to the counterparty credit risk of their broker-dealer, and the build-up of that unsecured counterparty credit in connection with unmargined TBA exposure could risk destabilization if a broker-dealer were to fail. Consistent with the TMPG Best Practices and the Basel-IOSCO Margin Framework,[14] FINRA should require that variation margin be posted *bilaterally*—including requiring members to post variation margin to customers where the broker-dealer has a mark-to-market loss on the TBA, whether or not the customer is a FINRA member.[15]

In addition to exposing TBA customers to increased counterparty credit risk, one-way variation margining of TBAs would impose liquidity risk by introducing asymmetry with the manner in which related instruments are margined. Market participants holding TBAs are subject to interest rate risk—if interest rates rise, the TBAs are likely to lose value. Market participants frequently hedge this risk with instruments such as cleared interest rate swaps and futures, which are subject to full two-way variation margining. As a result, if TBAs are not similarly subject to two-way margining, a decline in interest rates could cause mark-to-market losses on the interest rate swaps or futures, triggering variation margin payment requirements on those positions. At the same time, although the market participant has offsetting mark-to-market gains on the TBAs, it would not receive variation margin with which to offset its variation margin payment obligation. This could create considerable liquidity strain on the market participant. As a result, the Proposed Rules could force an entity which is economically healthy and well hedged to need to liquidate positions at fire sale prices solely to satisfy asymmetrical regulatory requirements that do not reflect economic reality.

IV. Margin Rules For Cleared TBAs Must be Addressed

The Proposed Rules would not apply to TBA transactions cleared through a registered clearing agency—in the case of TBAs, the Mortgage-Backed Securities

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[13] Treasury Market Practices Group, Frequently Asked Questions: Margining Agency MBS Transactions (Oct. 25, 2013) *available at* http://www.newyorkfed.org/tmpg/marginingfaq10252013.pdf.

[14] The Basel-IOSCO Margin Framework would similarly require *all* financial firms that engage in uncleared OTC derivatives to exchange variation margin. *See* Basel-IOSCO Margin Framework at 9.

[15] It is worth noting that the Basel-IOSCO Framework would also require that initial margin be posted bilaterally, not unilaterally as the Proposed Rules would require for TBAs. *See* Basel-IOSCO Framework at 4 ("Initial margin should be exchanged by both parties, without netting of amounts collected by each party (ie on a gross basis)….").

Division of the Fixed Income Clearing Corporation (the "**MBSD**"). Rather, the Regulatory Notice indicates that FINRA instead proposes to leave cleared TBA margin requirements to the MBSD. However, entirely excluding cleared TBA transactions from FINRA's margin regulations and retaining the status quo leaves customers at significant risk. Specifically, (i) cleared TBA customer margin held at its clearing broker is unprotected, (ii) customer assets passed through to the MBSD are unsegregated and exposed to risk of the clearing brokers' losses, (iii) customers receive no variation margin to protect against the clearing broker's default, and (iv) one-way margining creates the potential for liquidity stress unrelated to the health of the underlying portfolio. FINRA should therefore expand the scope of its Proposed Rules to address these matters so as to make sure that customers are protected to the same extent on cleared TBAs as we suggest above for uncleared TBAs.

A. Excess Margin Held at Clearing Broker Should be Protected

The rules of the MBSD ("**MBSD Rules**") only dictate the amount of margin that a clearing member is required to post based on that member's *overall* net positions in its clearing account. MBSD Rules do not specify the margin that a clearing member must obtain from its customers on customer positions, or the manner in which customer margin is handled. In practice, FINRA members that clear customer TBAs through the MBSD will require these customers to post initial and variation margin to the member. However, that margin is often greater than the margin the member is required to post to the MBSD, for example, because the clearing member's proprietary positions and positions of other customers may offset one another, reducing the risk of the clearing member's overall position at the MBSD.[16]

There are no MBSD Rules regarding the manner in which clearing members hold this customer "excess margin," and as discussed above, in the event of the clearing member's insolvency and SIPA liquidation, it would not be protected. In order to protect customers, consistent with our suggestion for the handling of customer uncleared TBA customer margin,[17] FINRA should require that FINRA members clearing TBAs for customers maintain all excess margin in a tri-party custody account and not hold this margin on their own books.

B. Customer Margin Passed Through to the MBSD Should be Segregated

Customer margin that is passed through by the clearing member to the MBSD is not protected in the event of the clearing member's insolvency. The MBSD Rules do not

[16] *See, e.g.*, MBSD Source Book (May 18, 2012), *available at* http://www.dtcc.com/~/media/Files/Downloads/Clearing-Services/FICC/MBSD/sourcebook.ashx ("**MBSD Sourcebook**") at § 10.1.1.

[17] *See supra* Section II.

distinguish between a clearing member's proprietary and customer positions or margin—no segregation of customer assets from proprietary assets is required. In fact, in the event of the insolvency of an MBSD clearing member, the MBSD Rules treat all assets that the MBSD holds for that clearing member as proprietary assets. As a result, in the event that a customer's clearing member broker-dealer becomes insolvent, the customer's margin passed through to the MBSD would be seized by the MBSD to cover any of the clearing member's proprietary losses or other liabilities to the MBSD.[18]

This result is, of course, antithetical to accepted concepts of customer protection. FINRA should urge the MBSD and the SEC to amend the MBSD's rules to provide for these essential customer protections.

C. One-Way Exchange of Variation Margin Creates Counterparty Risk

We note that the MBSD requires members to deposit variation margin to cover any mark-to-market losses on its aggregate position. The MBSD does not, however, pass on to members any mark-to-market gains.[19] As a result, clearing members similarly do not pay out variation margin to customers for any mark-to-market gains on customers' cleared TBAs. Consequently, customers are exposed to their clearing member's credit risk for any mark-to-market gains until settlement.

Clearing members may be willing to accept the MBSD's credit risk with respect to unsecured mark-to-market gains (because, among other reasons, members know that the MBSD will always hold a corresponding mark-to-market payment from another member). But a TBA customer does not have the same comfort—if its clearing member were to become insolvent, the MBSD would treat the customer's gains as assets of the clearing member available to offset any other losses or other liabilities of the clearing member to the MBSD.

D. One-Way Exchange of Variation Margin Creates Liquidity Risk

Finally, as discussed in the context of uncleared TBAs above, the practice of one-way variation margining—to which the MBSD's current approach to margining is effectively equivalent—creates the potential for liquidity stress on customers who are in fact well hedged. Losses on hedges in the futures or cleared interest rate swaps will require the posting of margin in the form of cash, while under the current MBSD regime, the offsetting gains in cleared TBAs will not generate cash to cover these requirements.

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[18] *See, e.g.*, MBSD Rule 4, § 7.

[19] *See, e.g.*, MBSD Sourcebook at § 10.1.5 ("The concept of a daily [mark-to-market] "pass through" does not exist at this time for MBSD. In its unrealized form, [mark-to-market] (as a [Deterministic Risk Component]) is part of the daily Clearing Fund Total Required Fund Deposit with associated charge implications ….").

We suggest that FINRA enhance the protection of its members' cleared TBA customers by requiring members to post variation margin to customers, even on cleared TBAs. Of course, these members will not have access to variation margin to pass on to customers on cleared TBAs if the MBSD does not pass it on, as is its practice today. As a result, we would expect that these members would either maintain their customer TBAs on an uncleared basis, or engage in discussions with the MBSD regarding updating its variation margin methodology.

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Brevan Howard appreciates FINRA's consideration of its views. Please do not hesitate to contact me with any questions at aron.landy@brevanhoward.com.

Sincerely yours,

Aron Landy
Chief Risk Officer