SANDLER

O'NEILL +

PARTNERS

March 28, 2014

Via Electronic Delivery Only
To pubcom@finra.org

Ms. 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 Sandler O'Neill & Partners, L.P. ("Sandler O'Neill" or the "Firm"), 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 (the "Notice") that contains proposed amendments to FINRA Rule 4210 for transactions in the TBA Market (the "Proposed Amendments"). By way of background, Sandler O'Neill is a fully disclosed, independent full-service broker-dealer, also operating as a non-primary, middle market dealer in Covered Agency Securities, as defined in the Proposed Amendments. The Firm promptly transmits all customer funds and securities to its clearing firm and otherwise qualifies for the exemption from the requirement to maintain physical possession and control of securities carried for the account of customers, as described in Rule 15c3-3(k)(2)(ii) under the Securities Exchange Act of 1934 (the "Exchange Act"). Sandler O'Neill is also a signatory to SIFMA's comment letter on the Proposed Amendments dated March 28, 2014, and agrees with and supports the comments made by other market participants in response to the Proposed Amendments.

We write separately, however, to seek relief from the financial burdens, among others, that the Proposed Amendments would place on smaller, non-primary dealer firms like ours, and to seek clarity on the responsibilities of clearing firms and fully disclosed introducing broker-dealers. As FINRA knows, non-primary dealer market participants vary in size, volume and market activity. Not all of the aforementioned firms are structured in the same way, and not all of these firms face all of the same issues. As a result, and as discussed below in more detail, Sandler O'Neill requests that FINRA make changes to the Proposed Amendments to address the

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potentially disproportionate impact on firms like ours, and otherwise provide clarification on certain aspects of the Proposed Amendments.

A. Disproportionate Impact on Smaller Firms

Sandler O'Neill believes that the Proposed Amendments, as currently drafted, will likely have a disproportionately negative impact on smaller, non-primary dealer firms like ours. Smaller firms in this context are firms that have far smaller capital levels than larger firms – millions on their balance sheets versus billions. In particular, the compliance costs associated with the Proposed Amendments are expected to total in excess of a million dollars for Sandler O'Neill. The projected increased costs are largely attributable to the foreseeable need to lease, purchase or develop new technology solutions to manage the margining process. In addition, Sandler O'Neill reasonably anticipates that it will need to hire multiple employees with accounting, compliance, legal, and operational backgrounds to cover the Firm's increased margining responsibilities under the Proposed Amendments. In fact, the compliance costs could prove to be so prohibitively high that smaller, non-primary dealer firms like ours could make the business decision to forego trading in Covered Agency Securities altogether, resulting in fewer choices and less price competition for customers that are interested in these securities.

The Proposed Amendments, if adopted, also would create financial hardships for smaller, non-primary dealers like us seeking to comply with the net capital rule in Exchange Act Rule 15c3-1. For example, several provisions in the Proposed Amendments would require firms to take charges against their net capital when they do not or cannot collect margin from customers and counterparties, or provide notification to FINRA if they exceed certain concentration limits. Such additional charges are likely to severely strain the balance sheets of smaller, non-primary dealers like us. The proposed concentration limits alone could constrain trading and liquidity, as 5% to a firm with a balance sheet in the millions may be a much, much smaller amount than 5% to a firm with a balance sheet of many billions of dollars. The result would be that smaller firms may constrain their trading in an attempt to prevent reaching the concentration limits listed in the Proposed Amendments. In addition, the Proposed Amendments suggest a minimum transfer amount ("MTA") below which a firm need not collect margin, provided that the firm takes a net capital charge for all uncollected margin under the MTA. On a volatile trading day, however, the foregoing requirement could lead a small firm to exceed its minimum net capital requirement and thereby jeopardize the firm's ability to operate. A number of smaller trades could add up quickly to a very large net capital charge. As a result of the foregoing, Sandler O'Neill requests FINRA to revise the Proposed Amendments to reduce the financial impact on smaller, non-primary dealers like ours.

B. Responsibilities of Clearing Firms v. Introducing Broker-Dealers

Certain introducing broker-dealers have arrangements with their clearing firms that allow the clearing firms to hold the broker-dealer's customer accounts on the clearing firm's books and records. As noted above, Sandler O'Neill qualifies for and operates pursuant to the exemption to Exchange Act Rule 15c3-3 (Customer Protection--Reserves and Custody of Securities). The Rule specifically states that the provisions of 15c3-3 are not applicable to a firm

> [w]ho, as an introducing broker or dealer, clears all transactions with and for customers on a fully disclosed basis with a clearing broker or dealer, and who promptly transmits all customer funds and securities to the clearing broker or dealer which carries all of the accounts of such customers and maintains and preserves such books and records pertaining thereto pursuant to the requirements of Rule 17a-3 and Rule 17a-4 of this chapter, as are customarily made and kept by a clearing broker or dealer.

Exchange Act Rule 15c3-3(k)(2)(ii).

This arrangement means that capital charges related to customer accounts are taken by the clearing firm, and not by the introducing broker-dealer. Introducing broker-dealers pay their clearing firms certain fees for this arrangement, and the risk is essentially absorbed by the clearing firm. This arrangement also permits the introducing broker-dealer to maintain a lower minimum net capital under Exchange Act Rule 15c3-1.

The Proposed Amendments, however, threaten to disrupt the above-described arrangements with respect to fixed income products in the TBA Market. In particular, it is unclear from the Proposed Amendments what proposed net capital requirements would fall on an introducing broker-dealer and what proposed requirements would be handled by the clearing firm in such a situation. Generally speaking, the Proposed Amendments require that if sufficient margin is not collected for transaction amounts under the MTA or when certain concentration limits are exceeded, a firm will be required to deduct the uncollected amount from that firm's net capital at the close of business the following day. Sandler O'Neill submits that it is entirely appropriate for the clearing firm to take these charges, as the customer accounts in question are on the clearing firm's books and records, and not on the books and records of the introducing broker-dealer. There is, however, not enough guidance in the Proposed Amendments to know which party should take the relevant charges; and importantly, there seems to be confusion

within the industry as to whom the responsible party should be for the purposes of calculating, collecting and holding custody of margin.

Additionally, the role of the clearing firm raises a question concerning margin collection. As previously noted, all accounts opened by Sandler O'Neill sit on the books of its clearing firm. At present, it is unclear whether Sandler O'Neill and similarly situated introducing broker-dealers would be deemed to have collected margin if the accounts themselves are controlled by the clearing firm. Similarly, it is also unclear whether the margin collected would be credited to the clearing firm or whether Sandler O'Neill would have to take net capital charges in the amount of the margin whether or not it is collected. It should be noted that introducing broker-dealers operating pursuant to the exemption under Exchange Act Rule 15c3-3(k)(2)(ii) are unable to rehypothecate any collected margin, placing such introducing broker-dealers at an even greater disadvantage vis-à-vis larger firms. Additional guidance is needed as a result.

It also should be noted that the larger the role of the clearing firm, the more expensive it will be for introducing broker-dealers to clear through those firms. It is entirely reasonable for clearing firms to charge more when they are doing more, but FINRA should be aware that the clearing costs associated with Covered Agency Securities will likely rise as a result of the Proposed Amendment, adding yet another cost for introducing broker-dealers. This will likely be true regardless of which party has the responsibility for the net capital charges, as the Proposed Amendments will require additional accounts to be opened to process margin, which will likely result in higher clearing fees. As a result, we again ask FINRA to analyze the disparate financial impact that the Proposed Amendments will have on smaller, non-primary dealers like ours.

C. Clarification Concerning Investment Advisor Accounts is Needed

The Proposed Amendments also provide that margin must be collected separately for sub-accounts of Investment Advisors and similar entities. There are, however, several challenges associated with this proposed requirement that may be difficult to overcome unless FINRA provides additional guidance. At present, broker-dealers do not typically know the identity of the customers in the sub-accounts until post-trade. Allocations are largely provided on a T+1 basis, and only at that time does the broker-dealer know the identity of the customer in the sub-account. Investment Advisors take the responsibility for conducting the relevant "Know-Your-Customer" and Anti-Money Laundering reviews of the customers in the sub-accounts, and the Investment Advisors generally make representations to the broker-dealers that they have completed the aforementioned reviews. Requiring separate margin accounts for sub-accounts of

Investment Advisors could, without specific exemption, trigger the need to conduct Know-Your-Customer and Anti-Money Laundering reviews of each customer in a sub-account.

In addition, Investment Advisors may be contractually prohibited from disclosing the identity of and details about their customers. The customers themselves may not want their identities disclosed to broker-dealers. Moreover, it will likely be extremely difficult for broker-dealers to collect margin directly from the Investment Advisor's customers. The mechanics for this practice are virtually unknown, and it is easy to imagine a customer's reticence to cooperate when receiving a margin call from an entity with whom the customer does not even have a business relationship.

One alternative is to allow broker-dealers to collect aggregated margin from the Investment Advisors in a single account. Such an approach would allow broker-dealers to manage their risk by collecting the necessary margin, without disrupting the relationship between the Investment Advisor and the Investment Advisor's customers. As a result, we request FINRA to consider the above-described approach and provide additional guidance regarding the sub-accounts of Investment Advisors.

D. TMPG Best Practices as a Guideline

The Treasury Market Practice Group's ("TMPG") Best Practices for Treasury, Agency Debt and Agency Mortgage-Backed Securities Markets (the "TMPG Best Practices") started the process of building protections in the area of Covered Agency Securities. Furthermore, all of the primary dealers put into place significant policies and procedures in order to comply with the TMPG Best Practices by December 31, 2013. As a condition to continue trading with many primary dealers, Sandler O'Neill had to create – from scratch – the ability to put up and collect margin, a process that required new technology solutions, practices and processes. This was a time consuming and costly initiative, but a necessary one to continue trading in Covered Agency Securities.

The Proposed Amendments, however, differ significantly from the TMPG Best Practices, meaning that entirely new technology systems, practices and processes would have to be created to comply with the Proposed Amendments as written. This will require significant and costly changes by Sandler O'Neill and many other firms to ensure compliance with the rule. The impact could be lessened if FINRA were to better track the Proposed Amendments to the TMPG Best Practices, and eliminate the maintenance margin, margining of fails, MTA and liquidating action requirements from the Proposed Amendments. As they currently stand, the Proposed

Amendments will require the Firm to engage in a costly and time -consuming restructuring of the existing technology, programs and policies and procedures only recently put into place to comply with the TMPG Best Practices.

E. Conclusion

In conclusion, Sandler O'Neill believes that significant changes and greater clarification should be provided in connection with the Proposed Amendments to ensure that smaller, introducing broker-dealers – and the investor market they serve – are not unfairly and unduly impacted by the proposals. Please feel free to contact me at (212) 466-7997 or Rebecca Ebert at (212) 466-8088 if we can provide any additional information for your consideration.

Sincerely,

Christopher S. Hooper
Principal & General Counsel