Marcia E. Asquith
Senior Vice President and Corporate Secretary
FINRA

Via E-mail

Ms. Asquith:

Thank you for the opportunity to comment on the proposed amendments to FINRA Rule 4210. While generally, the Rule represents an understandable attempt to address an issue that can, in fact, represent "systemic risk"; the manner in which FINRA has chosen to address this issue will create more problems than it solves.

Although it can certainly be said that the Rule as drafted will affect market liquidity, possibly drive clients away from FINRA members and perversely, for a Rule that attempts to mitigate systemic risk, requires maintenance margin only from those whose activities cannot create systemic risk; I will focus on the one issue that drives most of the others. Many of the problems that would be created by adopting the amendments as proposed are related to the fact that FINRA has chosen to define all TBA (a term I will *not* use interchangeably with specified MBS and CMO markets), specified MBS and CMO transactions as "Covered Agency Securities" and treating them in generally the same manner. Doing so ignores the size and nature of the markets as well as the effect the proposal will have on market participants.

The TBA market and the specified MBS and CMO markets are dissimilar in nature. Although the TMPG report included the specified MBS and CMO markets with the TBA market, they did not claim that all markets are margined. In Notice 14-02, FINRA cites the TMPG "Margining in Agency MBS" report in claiming that "Historically, the TBA market is one of the few markets where the exchange of margin has not been a common practice". That is not what the report found. The direct quote from the TMPG report in reference to forward Agency MBS was as follows: "This contrasts with practices in other forward, repo, securities lending, and derivatives markets." TMPG did not contrast the TBA market to "other markets", but to other *contract* markets. The specified MBS and CMO markets are not historically "contract markets", but are markets in actual investment securities (yes, I realize that all markets involve contracts) that generally settle within the month of the trade. Consequently, the settlement risk involved in this type of market is far different (and arguably considerably less) than that posed by an actual "contract" market such as the TBA market where half of the activity (par volume-Q1 through Q3 2013: 51.3 percent dollar roll activity) is merely a financing mechanism and a considerable portion of the remainder is speculation.

The TBA market and the specified MBS and CMO markets are dissimilar in size. 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 MBS and CMO markets combined, and that figure is understated since it based upon original face value. Any regulation that addresses the TBA market addresses approximately 90 percent of the risk created by the size of the combined markets, without even considering the difference in the nature of the markets.

The size of the specified MBS and CMO markets does not represent a systemic risk. Although the total principal value outstanding at any one time is a frighteningly large amount-although it pales in comparison to the TBA market- the risk that might actually be incurred is much smaller. A 100 basis point move in the mortgage market over a ten business day period would result in less than four billion dollars [30.7B (average daily MBS/CMO trading volume) x 10(days) x .065 (price movement of 100 bps with an estimated 8.0 year average life) x .80 (estimated average factor of MBS/CMO traded) x .25] in exposure even if transactions representing 25 percent of the volume failed to settle. This also assumes that none of the 68 percent of the par value traded in quantities 25 million and larger is margined by agreement, and that is highly unlikely.

The cost of compliance is excessive and falls disproportionately on smaller broker–dealers. Smaller broker-dealers are much more likely to be involved in the specified MBS and CMO markets than in the TBA markets: since a smaller broker–dealer is less likely to have a margin department in place; the proposed amendments will affect smaller broker-dealers disproportionately. The costs of requiring each firm to obtain an executed MSFTA from each account and sub-account will be substantial. That is to say nothing of the costs of establishing a margin department in firms that heretofore transacted business almost exclusively on a delivery versus payment basis in cash accounts. It is estimated that the costs of compliance with the proposed new rule at our firm will be in the low six figures annually and that includes adding at least one extra position. Multiply that system-wide and the annual costs of the new proposal, as drafted, exceed the risk that the Rule amendments seek to mitigate. I cannot begin to describe the operational nightmare that would result from each retail and small institutional investor converting all “good settlement” activity to T+1 or T + 3, and the cancellation and correction tickets required, in order to avoid margining every MBS and CMO transaction (admittedly, an operational nightmare of its own).

Retail clients will be affected. As to the canard that retail does not participate in the “Covered Agency Security” market; TRACE statistics reveal that retail participates significantly in the specified MBS and CMO markets . According to the TRACE fact sheet (a FINRA publication), 51 percent of the transactions (about three quarters of a million trades annually) in the specified MBS and CMO markets in the first three quarters of 2013 involved par value (face amount, not current balance) of less than one hundred thousand dollars. That is the precise market segment which, over the years, I have repeatedly heard FINRA officials refer to as the retail segment. Even a casual glance at the available information leads one to the conclusion that there is significant retail participation in the specified MBS and CMO markets.

The proposal as drafted fails to consider the relative size and nature of the TBA and specified MBS and CMO markets. The inclusion of the specified MBS and CMO markets in the definition of “Covered Agency Security” places an unreasonable operational and cost burden on broker-dealers that would be otherwise unaffected by this subsection of the Rule, particularly in comparison to the actual risk that is mitigated. Additionally, the amended Rule will leave in its wake a swarm of bewildered retail investors.

FINRA went to great lengths to analyze the effects that margining the TBA market would have on all participants, and drafted a proposal reflecting that analysis. The decision to define specified MBS and CMO transactions as interchangeable with TBA transactions is reflective of no such analysis. I urge FINRA to consider re-drafting the proposal and apply the margining rules therein strictly to actual TBA transactions. In the event that after further review FINRA considers it necessary to require broker-dealers to adopt a margin protocol for all MBS and CMO transactions; at the minimum, the protocol should not be applied to any transaction that settles on the first day of the month that good factors become available.

Thank you again for the opportunity to comment on the proposal.

Sincerely,

Chris Melton
Executive Vice President
Coastal Securities