

March 21, 2014

Marcia E. Asquith
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, DC 20006-1506

Dear Ms. Asquith,

On behalf of Brean Capital, a full service investment bank with a significant involvement in the Mortgage Backed Securities ("MBS") Markets, I thank you for the opportunity to comment on FINRA's proposed amendments to FINRA Rule 4210 for Transactions in the TBA Market, as published in regulatory notice 14-02. It's a topic that I, and others at Brean, have given a great deal of thought.

To begin, FINRA asks if the imposition of mandatory margin requirements will negatively impact liquidity and pricing in this market and if so, in what ways?

We believe that the rule, as proposed, will lead to fewer regional dealers, banks and mortgage originators participating in the Mortgage Backed Securities market, thus leading to less liquidity in the marketplace, negatively impacting all holders of MBS, as well as those seeking a mortgage, and mortgage rates in general. Mortgage rates, set by originators, are ultimately determined by what price investors are willing to pay for the loans, or securities, in the secondary marketplace. To the extent that MBS in the secondary market trades less efficiently, rates on new mortgages will go higher.

While regional dealers provide a great deal of liquidity in the MBS market, especially the secondary market, they typically don't have balance sheets to support the greater burden of additional margin posting. They tend to serve the role of liquidity provider by matching buyers and sellers of secondary, less liquid MBS, often using little balance sheet in the process. They also tend to serve smaller mortgage originators. Regional dealers simply will not have the capital available to meet the new margin requirements, and will be forced out of the market. For those dealers that do use capital, they will have less available to provide liquidity, as they'll have to set aside capital to meet potential margin calls. The cost of having idle capital, along with the costs of building or expanding a margin department, will have a detrimental impact for smaller participants in a market place that operates on slim margins as it is. Accordingly, many more will be forced out of the MBS market, while others will have to reduce the depth of their commitment to the market. Over time, the marketplace will move away from many small participants and consolidate to a handful of only the largest institutions. The reduction in competition, by consolidating the market to a handful of huge participants, will likely lead to wider spreads in all but the most liquid (new production) MBS product, and ironically also creates greater systemic risk than exists today.

FINRA also asks that because not all dealers in the TBA market are FINRA members, what is the potential that the proposal will result in a shift of the market to bank dealers that are non-FINRA participants?

We believe that the answer to that question is quite obvious. If a customer has the choice of dealing with a FINRA member counterparty that requires margin posting, or a bank dealer that doesn't, the customer will chose the non-FINRA counterparty, provided that pricing is fairly competitive, which it should be, as the non-FINRA member isn't burdened with the associated costs of posting/collecting margin. This is especially true of smaller mortgage originators, who simply do not have the capital to post in the event of a margin call. Originators use broker dealers to both self loans to, and to help them hedge their production pipeline, by selling forward settling TBA's against their forward rate lock commitments. To the extent smaller originators can find non-FINRA banks with whom to transact, they certainly will. Many other customers of broker dealers, such as asset managers, insurance companies, hedge funds and regional banks will likely do the same. Banks with capital markets groups are thrilled at the prospect of this.

We believe there will be other unintended consequences as a result of the margin posting requirement, potentially causing problems for the MBS marketplace which do not exist today. One example of that is a greater number of trades being settled on non-current factors, or incorrect values, to avoid margin posting. MBS have changes in "factor" (the remaining loan balance) every month, a significant reason why MBS tend to have longer forward settlements than other bonds. Factor information is released on the evening of the fourth business day of the month. Currently, trades that occur near month end, or at the very beginning of a month, tend to settle on "good day" a standardized settlement date each month, after all parties know the new factor and can accurately settle the trade. But to avoid margin posting, parties will likely settle trades T+1, and will then cancel and rebill the trade after the new factor is released. The result of this will be unprecedented unsecured debit and credit balances amongst market participants. We believe that at a minimum, participants should be allowed T+7 settlements on non-centrally cleared MBS trades before a margin demand would occur. By allowing the extra days, the settlement process would be much smoother, as parties would be less inclined to settle T+1 with incorrect factors, just to circumvent the margin posting requirement.

Another unintended consequence of the proposal is related to the proposed close out requirement. This is particularly troublesome on many levels. In the simplest example, an institution or counterparty may be unable to post margin on only one single trade, and the trade is forced to be closed out. In the secondary mortgage market, where older, seasoned securities develop unique characteristics, closing out a trade can cause a chain reaction of problems. For example, if a dealer is forced to close out one side of a trade, but has already sold the security to a third party as they often do, the dealer will have to find a substitute security to deliver to the third party. Now the dealer is burdened with the challenge of finding a suitable substitute security to deliver, which may be difficult, and is at the mercy of the third party to agree to the substitution. This can be a long process, and may result in monetary damages to the dealer who was forced to close out the trade. Had the trade not been closed out, it likely would have settled. But the reality of a party failing to post margin on a single trade is remote. The more likely scenario is that an institution is in a liquidity crunch or crisis, and is unable to post margin on a multitude of trades, to several counterparties. If all of the counterparties close out their respective open trades lacking sufficient margin, it will likely result in the quick demise of the troubled institution. It will also be very disruptive to the marketplace, more so than if all of the counterparties of the troubled institution had open fails with the institution, as was the case with Lehman Brothers. In the case of Lehman Brothers, where Lehman stood in the middle of multi Billon Dollars of trades, the ultimate parties were brought together, and the trades were ultimately settled, with relatively little disruption to the MBS market. That wouldn't have been the case if Lehman's counterparties arbitrarily closed out their trades with Lehman. In a marketplace where counterparties are inextricably linked, the notion of close out actually creates more systemic risk than reducing it.

As it applies to forward settling MBS transactions, the concern, or risk, is primarily around securities transactions which are not settled on a centralized clearing exchange, such as MBSCC, or where one or both parties to the transaction are not MBSCC members. For MBSCC members, or firms who clear through MBSCC members, members post collateral in respect of cleared trades, which are netted against all other trades of such party on the centralized clearing exchange, thus reducing the overall collateral requirement to an amount that is appropriate for the aggregate level of risk to a particular institution. Unfortunately, only certain MBS trades (TBA trades and trades of fixed rate specified pools) are currently traded through MBSCC. This currently leaves a very significant number of actively traded MBS, including Adjustable Rate GNMA's, FNMA's and FHLMC's and GNMA HECM's (reverse mortgage GNMA's) outside the clearing exchange. If trades in these securities were required to settle and net on MBSCC (or a similar centralized clearing system) and participants trading them were required to be netting members, a major concern of forward risk would be taken off the table. Ultimately, all mortgage bond trades should be required to settle and net on a centralized clearing exchange. This would result in a significantly more efficient deployment of capital than bilateral collateral posting, which, without netting, is insensitive to the true risk posed by a party's aggregate open trades, and would require total capital from dealers that is disproportionately in excess of the risk, forcing many from the market. This alternative would also be a safer and more cost effective approach than requiring dealers to move funds around daily, possibly for weeks at a time on just a single transaction, and putting the dealer at risk to an institution that could fail, taking the dealer's posted collateral with it, and leaving the dealer with an open trade.

Since the proliferation of the MBS Market firms large and small have failed, some heavily involved in the MBS market, and yet I have never experienced or heard of the failure to ultimately settle open trades with one of the failed firms. The thought of adding a huge additional burden onto the market out of a fear that the mechanisms and best practices that have worked so well over the years is without merit and not borne out by any past example. I sincerely hope that Regulatory notice 14-02 is reconsidered.

Very truly yours,

Robert M. Fine

Chief Executive Officer