Regulatory Notice 14-02

Margin Requirements

FINRA Requests Comment on Proposed Amendments to FINRA Rule 4210 for Transactions in the TBA Market

Comment Period Expires: February 26, 2014

January 2014

Notice Type

- Request for Comment

Suggested Routing

- Compliance
- Legal
- Margin Department
- Operations
- Regulatory Reporting
- Risk Management
- Senior Management

Key Topics

- Agency Mortgage-Backed Securities
- Margin
- TBA Market

Referenced Rules & Notices

- FINRA Rule 4210
- FINRA Rule 6710
- NTM 03-73
- SEA Rule 15c3-1

Executive Summary

FINRA is seeking comment on proposed amendments to FINRA Rule 4210 to establish margin requirements for transactions in the To Be Announced (TBA) market.[1] The proposal, designed to reflect the growth of the TBA market and to replace current interpretive materials under Rule 4210 that have become outdated, is informed by the set of best practices adopted by the Treasury Market Practices Group (TMPG) of the Federal Reserve Bank of New York (FRBNY). Consistent with the overarching goal of many regulatory initiatives since the financial crisis, the proposal aims to reduce counterparty credit risk. The proposal would accomplish this in the TBA market by addressing, among other things, maintenance margin and variation (also referred to in the proposed rule language and this *Notice* as mark to market) margin requirements, risk limit determinations, concentrated exposures, and exemptions for de minimis transfer amounts and for transactions cleared through registered clearing agencies. The proposed rule amendment is available as Attachment A at www.finra.org/notices/14-02.

Questions regarding this *Notice* should be directed to:

- Glen Garofalo, Director, Credit Regulation, at (646) 315-8464;
- Peter Tennyson, Director, Broker-Dealer Operations and Financial Responsibility, at (646) 315-8403;
- Adam H. Arkel, Associate General Counsel, Office of General Counsel, at (202) 728-6961.

Action Requested

FINRA encourages all interested parties to comment on the proposal. Comments must be received by February 26, 2014.

Financial Industry Regulatory Authority

Comments must be submitted through one of the following methods:

- Emailing comments to *pubcom@finra.org*; or
- Mailing comments in hard copy to:

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

To help FINRA process comments more efficiently, persons should use only one method to comment on the proposal.

Important Notes: All comments received in response to this *Notice* will be made available to the public on the FINRA website. In general, FINRA will post comments as they are received.[2]

Before becoming effective, a proposed rule change must be authorized for filing with the SEC by the FINRA Board of Governors, and then must be filed with the SEC pursuant to SEA Section 19(b).[3]

Background & Discussion

Most trading of agency mortgage-backed securities (MBS) takes place in what is generally referred to by industry participants as the TBA market, which is characterized by transactions with forward settlements as long as six months past the trade date.[4] Agency MBS is one of the largest fixed income markets, with $5 trillion of securities outstanding and approximately $750 billion to $1.5 trillion in gross unsettled and unmargined dealer to customer transactions.[5]

Historically, the TBA market is one of the few markets where the exchange of margin has not been a common practice, thereby creating a potential risk from the counterparty exposure. Futures markets, for example, require the daily posting of both initial and maintenance margin and variation margin on all exchange cleared contracts. Market convention has been to exchange margin in the repo and securities lending markets, even when the collateral consists of exempt securities. The FRBNY recognized the existence of this gap and charged the TMPG with establishing standards regarding the margining of forward-settling agency MBS transactions. The TMPG has noted:

> To the extent that they remain unmargined, uncleared agency MBS transactions can pose significant counterparty risk to individual market participants. Moreover, the market's sheer size . . . raises systemic concerns. If one or more market participants were to default on forward-settling agency MBS trades, the agency MBS market

> could transmit losses and risks to a broad array of other participants. While the transmission of these risks may be mitigated by the netting, margining, and settlement guarantees provided by a [central counterparty], losses could nonetheless be costly and destabilizing. Furthermore, the asymmetry that exists between participants that margin and those that do not could have a negative effect on liquidity, especially in times of market stress.[6]

The best practices the TMPG[7] adopted are only recommendations—they are not requirements.[8] Unsecured credit exposures that exist in the TBA market today can lead to financial losses by members. Permitting counterparties to participate in the TBA market without posting margin can facilitate increased leverage by customers, thereby potentially posing a risk to the member extending credit and to the marketplace as a whole. Further, FINRA's current interpretive guidance[9] for the TBA market has not been updated since the financial crisis. In view of the growth in volume in the TBA market, the number of participants and the credit concerns that have been raised in recent years, FINRA believes there is a need to establish FINRA rule requirements that will extend responsible practices to all members that participate in this market.

Accordingly, FINRA is seeking comment on proposed amendments to FINRA Rule 4210 to establish margin requirements for the TBA market. Specifically, the proposed rule change applies to TBA transactions (inclusive of ARM transactions), Specified Pool Transactions, and transactions in CMOs, with forward settlement dates (for purposes of the proposed amendments, these are defined below collectively as Covered Agency Securities—for simplicity, throughout this *Notice* the terms "Covered Agency Securities" and "TBA market" are used interchangeably). The proposed rule change is informed by the TMPG best practices. Further, the scope of products the proposed amendments cover is intended to be congruent with those covered by the TMPG best practices, including updated guidance that the TMPG has released since the TMPG issued the original best practices.[10]

Summary of Proposed Amendments

Broadly, the proposed rule change provides that all members would be required to collect variation margin for transactions in Covered Agency Securities when the current exposure exceeds $250,000. In addition, members would be required to collect maintenance margin for transactions with non-exempt counterparties (as discussed further below). A summary of the key aspects of the proposed amendments follows:

- **Definition of "Covered Agency Securities":** As noted earlier, the proposed amendments apply to "Covered Agency Securities," the scope of which is designed to be congruent with the products covered by the TMPG best practices. The term is defined to include:
  - TBA transactions, as defined in Rule 6710(u),[11] for which the difference between the trade date and contractual settlement date is greater than one business day, inclusive of ARM transactions;

  - Specified Pool Transactions, as defined in Rule 6710(x),[12] for which the difference between the trade date and contractual settlement date is greater than one business day; and
  - transactions in CMOs, as defined in Rule 6710(dd),[13] issued in conformity with a program of an Agency, for which the difference between the trade date and contractual settlement date is greater than three business days.
- **Risk Limits:** Informed by current interpretations of FINRA rules, members that engage in Covered Agency Security transactions with any counterparty[14] will be required under the proposal to make a determination in writing of a risk limit to be applied to each such counterparty.[15] The proposal further requires that the risk limit determination must be made by a credit risk officer or credit risk committee in accordance with the member's written risk policies and procedures.[16] The proposal permits members of limited size and resources that do not have a credit risk officer or credit risk committee to designate an appropriately registered principal to make the risk limit determinations.
- **Registered Clearing Agencies:** Transactions cleared through a registered clearing agency, and subject to the margin requirements of that clearing agency, will not be subject to the proposed requirements.
- **Transactions with Exempt Counterparties:** For purposes of the proposed amendments, an exempt counterparty is an "exempt account" as that term is defined under Rule 4210(a)(13).[17] The proposal provides that for transactions with exempt counterparties, maintenance margin will not be required. 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).[18] The proposal provides that the amount of any uncollected mark to market loss must be deducted in computing the member's net capital as provided in SEA Rule 15c3-1 at the close of business following the business day the mark to market loss was created. Further, if variation margin is not posted to secure the mark to market loss within five business days from the date the loss was created, the member is required to promptly take liquidating action, unless FINRA grants the member an extension. This differs from FINRA's current interpretation to Rule 4210 that permits members to only take a charge to net capital in lieu of collecting the mark to market loss from exempt accounts.[19] The proposal provides that members may treat mortgage bankers[20] that use Covered Agency Securities to hedge their pipeline of mortgage commitments as exempt accounts.[21]
- **Transactions With Non-Exempt Accounts:** The proposal provides that for transactions with non-exempt accounts, members must collect variation margin and must collect maintenance margin equal to 2 percent of the market value of the securities. FINRA notes that the maintenance margin requirement of 2 percent would include mortgage

banker transactions that exceed the hedge necessary to cover the mortgage pipeline, as well as speculative transactions. To the extent such margin is not collected, the member will be required to deduct such amount from the member's net capital as provided in SEA Rule 15c3-1 at the close of business following the business day the deficiency was created. Further, if such required margin is not collected within five business days, the member must take liquidating action. This differs from the current interpretations to Rule 4210, which impose a 5 percent margin requirement plus any mark to market loss for any non-exempt accounts.[22]

- **De Minimis Transfer:** Recognizing the potential operational burden of collecting margin and consistent with other OTC derivatives markets, FINRA proposes to provide for a minimum transfer amount of $250,000 (the "*de minimis* transfer amount") below which the member need not collect margin (provided the member deducts the amount outstanding in computing net capital as provided in SEA Rule 15c3-1 at the close of business the following business day).
- **Concentrated Exposures:** The proposal establishes a new reporting obligation with respect to concentrated credit exposures. Specifically, a member would have a written notification requirement to FINRA and would be prohibited from entering into any new transactions that could increase credit exposure if net capital deductions, over a five business day period, exceed:
  - **for a single account or group of commonly controlled accounts:** 5 percent of the member's tentative net capital; or
  - **for all accounts combined:** 25 percent of the member's tentative net capital.
- **Determination of Exempt Account:** The proposal clarifies that the determination of whether an account meets the definition of exempt account must be based upon the beneficial ownership of the account. The proposal provides that sub-accounts managed by an investment adviser (where the beneficial owner is other than the investment adviser) must be margined individually. Members that do not already operate in this way will need to conform their practice accordingly.
- **Central Banks:** The proposal will not apply to transactions with central banks.[23]

Request for Comment

FINRA is requesting comment on all aspects of the proposal, including costs and burdens that the proposal could impose. In particular, FINRA seeks comment on the following issues:

- **Market Participants and Consistency With Other Regulatory Regimes:** FINRA believes that instituting mark to market and maintenance margin requirements is consistent with regulatory regimes in other markets, such as the futures and other contract markets, where participants are subject to daily mark to market and initial margin. TBA market participants include FINRA members,[24] banks, hedge funds, mutual funds, mortgage bankers and other institutional customers. FINRA believes that there are few retail customers that participate directly in this market. Many of the members and counterparties that participate in this market will collect variation margin in the TBA market in conformance with the TMPG best practices. What types of market participants will be impacted by these proposals? Will these rules have a direct and measureable impact on retail customers? If so, what are they?

- **Impact on Market Participants:** In developing the proposal, FINRA staff has engaged in conversations with various industry participants, including firms of varying sizes. While FINRA believes that the proposed rule change will reduce systemic risk, it may impact market participants in a number of ways:
  - First, will FINRA's imposition of mandatory margin requirements negatively impact the liquidity and pricing in this market? If so, in what ways?
  - Second, the posting of margin will require additional liquidity on the part of market participants. Larger dealers will likely not be significantly impacted by the additional liquidity needs resulting from posting variation margin. However, mid-size and smaller dealers may be presented with liquidity constraints as a result of the need to post variation margin to a counterparty without the ability to collect from another counterparty when one side of their transaction is cleared through Mortgage-Backed Securities Clearing Corporation and the other side is bilateral. In addition, non-exempt customers may also face liquidity constraints in posting both variation and maintenance margin and may choose to limit their participation in the TBA market as a result. What would be the extent of these liquidity constraints? How will this impact market liquidity and pricing? How will different firms (*e.g.*, different sizes or different business models) be impacted?
  - Third, 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? Are there other impacts on FINRA members versus non-FINRA members that FINRA should consider?
  - Fourth, to what extent will the reduced leverage of a counterparty impact market liquidity and pricing? What are the potential impacts on consumers in the mortgage market?
  - Fifth, with respect to certain market participants, dealers and institutional customers alike, operational costs are likely to be incurred in developing the necessary compliance infrastructure. What would be the extent of these costs, both initially and for ongoing compliance?
  - Sixth, FINRA believes that there are approximately 30 non-clearing firms that participate in the TBA market. These firms are likely to incur additional costs from their clearing firms to establish margin practices that they may not have needed in the past. Such firms may choose to self-clear transactions, which may increase the operational risk at these firms as well as add to their cost of doing business. What would be the extent of these costs?

- Seventh, there are operational costs that firms will face with respect to the handling of collateral for investment adviser accounts. What costs would be incurred and what would be the extent of these costs?

- **Non-Exempt Accounts:** In developing the proposal, FINRA considered the appropriateness of applying maintenance margin requirements to non-exempt accounts. FINRA believes that doing so would be consistent with the proposal's purpose of reducing risk as non-exempt accounts may not have sufficient financial resources to absorb losses. As such, continuing to allow them to enter into TBA market transactions without posting maintenance margin would expose the broker-dealer and the market to greater risk. However, requiring maintenance margin may result in fewer non-exempt accounts participating in the TBA markets. Should FINRA reconsider the proposal's approach to non-exempt accounts? If so, why? What will be the impact to the market of requiring maintenance margin for non-exempt accounts? What would be the extent of any possible reduction in participation by non-exempt accounts? Do non-exempt accounts pose greater credit risk to market participants because of their smaller size and resources?
- **Mortgage Bankers:** FINRA believes that the proposal permits sufficient flexibility for mortgage bankers to continue to use Covered Agency Securities as a hedge to mortgage originations, while also addressing the low capital and liquidity that many mortgage bankers maintain. What is the impact of requiring mortgage bankers to post variation margin? Will this requirement lead to a change in behavior such that mortgage bankers choose not to participate in the TBA market? If so, what will the impact be? How will members ascertain that mortgage banker transactions are actually hedging transactions?
- **Eligible Collateral:** FINRA believes that all margin eligible securities, with the appropriate margin requirement, should be permitted as collateral to satisfy required margin. This would expand the current market convention of posting cash or U.S. Treasuries to include corporate and equity securities. Pursuant to FINRA Rule 4210, equity securities would receive 75 percent margin value. FINRA is seeking comment as to whether the expanded set of collateral is appropriate.
- **Close-out Requirements:** As noted earlier, the proposal requires the close out of transactions if a margin call has not been met within five business days. FINRA is soliciting comment on whether this timeframe is appropriate. Further, the rule permits an extension of time to be granted for the close out. What would be the anticipated impact of the close-out requirement as proposed? What factors should be considered in determining whether or not an extension is appropriate?
- **Collection of Call:** The proposal requires a margin call to be met by the close of business the following day. After that date, the member must take a charge to its net capital of the under-margined amount. What would be the anticipated impact of the collection of call requirement as proposed? Are there instances where this timeframe is too short and an extended timeframe should be considered?

- **Risk Limit Determinations:** The proposal requires that members that engage in TBA market transactions with any counterparty must make a determination in writing of a risk limit to be applied to each such counterparty. The risk limit determination must be made by a credit risk officer or credit risk committee in accordance with the member's written risk policies and procedures. The proposal further provides that members of limited size and resources that do not have a credit risk officer or credit risk committee may designate an appropriately registered principal to make the risk limit determinations. What would be the anticipated impact of the risk limit determination as proposed? Is this appropriate? Why? If not, why not?
- **De Minimis Transfer Amount:** As noted earlier, the proposal establishes a $250,000 *de minimis* transfer amount. What would be the anticipated impact of the *de minimis* transfer amount as proposed? Is this amount appropriate? If not, why not, and what should the amount be and why?
- **Effective Date:** Recognizing the operational and technology challenges, what is the appropriate amount of time needed to implement these changes? Is a six month period adequate or should a longer period of time be considered? What factors should be considered in determining whether an extension is appropriate?
- **Other:** Are there any other concerns that should be addressed?

Endnotes

1. For simplicity, throughout this *Notice* the term TBA market is used to refer to TBA transactions (inclusive of adjustable rate mortgage (ARM) transactions), Specified Pool Transactions, and transactions in Collateralized Mortgage Obligations (CMOs), with forward settlement dates. As further discussed in this *Notice*, the proposal defines these transactions as Covered Agency Securities.

2. FINRA will not edit personal identifying information, such as names or email addresses, from submissions. Persons should submit only information that they wish to make publicly available. *See NTM 03-73* (November 2003) (NASD Announces Online Availability of Comments) for more information.

3. *See* SEA Section 19 and rules thereunder. After a proposed rule change is filed with the SEC, the proposed rule change generally is published for public comment in the *Federal Register*. Certain limited types of proposed rule changes, however, take effect upon filing with the SEC. *See* SEA Section 19(b)(3) and SEA Rule 19b-4.

4. *See*, *e.g.*, the SEC's Staff Report of the Task Force on Mortgage-Backed Securities Disclosure.

5. *See* Report of the TMPG, Margining in Agency MBS Trading (November 2012) (referred to as the "TMPG Report"). The TMPG is a group of market professionals that participate in the TBA market and is sponsored by the FRBNY.

6. *See* the TMPG Report.

7. *See* Best Practices for Treasury, Agency Debt, and Agency Mortgage-Backed Securities Markets.

8. Absent the establishment of a rule requirement, the TMPG best practices could become more widely adopted over time by other market participants. However, this will take time and in the interim would leave firms at risk.

9. *See* Interpretations /01 through /08 of FINRA Rule 4210(e)(2)(F). Such guidance references TBAs largely in the context of Government National Mortgage Association (GNMA) securities. The modern TBA market is much broader than GNMA securities.

10. *See*, *e.g.*, TMPG Releases Updates to Agency MBS Margining Recommendation (March 2013).

11. FINRA Rule 6710(u) defines "TBA" to mean a transaction in an Agency Pass-Through Mortgage-Backed Security or an SBA-Backed ABS where the parties agree that the seller will deliver to the buyer a pool or pools of a specified face amount and meeting certain other criteria but the specific pool or pools to be delivered at settlement is not specified at the time of execution, and includes TBA transactions "for good delivery" and TBA transactions "not for good delivery." FINRA Rule 6710(v) defines "Agency Pass-Through Mortgage-Backed Security" as a type of Asset-Backed Security issued in conformity with a program of an Agency or a government-sponsored enterprise (GSE), for which the timely payment of principal and interest is guaranteed by the Agency or GSE, representing ownership interest in a pool(s) of mortgage loans structured to "pass through" the principal and interest payments to the holders of the security on a pro rata basis. FINRA Rule 6710(bb) defines SBA-Backed ABS similarly, though with reference to Asset-Backed Securities issued in conformity with a program of the Small Business Administration. FINRA Rule 6710(m) defines "Asset-Backed Security" to include, in part, a security collateralized by any type of financial asset, such as a loan, lease, mortgage, or a secured or unsecured receivable. Lastly, the term "Agency" is defined under FINRA Rule 6710(k).

12. Rule 6710(x) defines Specified Pool Transaction to mean a transaction in an Agency Pass-Through Mortgage-Backed Security or an SBA-Backed ABS requiring the delivery at settlement of a pool(s) that is identified by a unique pool identification number at the time of execution.

13. FINRA has filed paragraph (dd) of FINRA Rule 6710 for approval by the SEC. *See* SR-FINRA-2013-046. The rule will define CMO to mean a type of Securitized Product structured in multiple classes (or tranches) backed by Agency Pass-Through Mortgage-Backed Securities, mortgage loans, certificates backed by project loans or construction loans, other types of mortgage-backed securities or assets derivative of mortgage-backed securities, and includes a real estate mortgage investment conduit (REMIC) and an Agency-Backed Commercial Mortgage-Backed Security as defined in FINRA Rule 6710(ee) (which, like Rule 6710(dd), the staff has filed for approval by the SEC).

14. Under the proposal, a "counterparty" is defined as any person that enters into a Covered Agency Security transaction with a member and includes a "customer" as defined in paragraph (a)(3) of FINRA Rule 4210.

15. *See* Interpretation /03 of FINRA Rule 4210(e)(2)(F). Under the current interpretation, the risk limit determination is an alternative available to alleviate otherwise required net capital deductions or margin requirements, as applicable. FINRA notes that, as a matter of practice, most members have availed themselves of this relief and have applied risk limit determinations to TBA transactions in general. (To recap, Interpretation /03 of FINRA Rule 4210(e)(2)(F) provides that, in lieu of deducting from capital 100 percent of any marked to the market losses in exempt accounts and having to obtain margin as well as any marked to the market losses from non-exempt mortgage bankers' accounts, members may make a determination in writing of a risk limit for each such exempt account and non-exempt mortgage banker's account.)

16. FINRA believes that this requirement extends logically from the SEC's new Rule 17a-3(a)(23), which, in part, requires a broker-dealer with specified amounts of aggregate credit items or capital to document the "credit, market, and liquidity risk management controls established and maintained by the broker or dealer to assist it in analyzing and managing the risks associated with its business activities . . ." *See* Exchange Act Release No. 70072 (July 30, 2013), 78 FR 51824 (August 21, 2013) (Financial Responsibility Rules for Broker-Dealers).

17. Broadly speaking, exempt accounts include FINRA members, non-member registered broker-dealers, "designated accounts" under FINRA Rule 4210(a)(4) (including banks, savings associations, insurance companies, investment companies, states or subdivisions, or pension plans), and persons meeting specified net worth requirements and other conditions.

18. FINRA staff has consulted with the SEC staff concerning the net capital treatment of variation margin posted by a broker-dealer with a counterparty. It is anticipated that the SEC will issue guidance, such that if certain conditions are met, the resulting receivables can be treated as an allowable asset in computing net capital.

19. *See* Interpretation /04 of FINRA Rule 4210(e)(2)(F).

20. The proposal defines a "mortgage banker" as an entity, however organized, that engages in the business of providing real estate financing collateralized by liens on such real estate. FINRA notes that the definition is meant to include for example banks and credit unions, to the extent they originate mortgages.

21. This means that mortgage bankers must post variation margin and may need to post maintenance margin. Under FINRA's current interpretation, mortgage bankers with more than $1.5 million of net worth are not required to post variation or maintenance margin, within risk limits established by the member. *See* Interpretation /02 of FINRA Rule 4210(e)(2)(F).

22. *See* Exhibit I to Interpretations to FINRA Rule 4210(e)(2)(F). Note however that under the current interpretations transactions with delivery dates or contract maturity dates of 120 days or less from trade date do not currently require variation or maintenance margin, though any mark to market loss must be deducted from net capital. Further, FINRA currently allows five business days for the call to be met, before a capital charge is incurred. *See* Interpretation /05 of FINRA Rule 4210(e)(2)(F).

23. For purposes of the proposed rule change, 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. This approach is consistent with the approach taken in the standards established by the Basel Committee on Banking Supervision (BCBS) and the Board of the International Organization of Securities Commissions (IOSCO). *See* BCBS and IOSCO Margin Requirements for Non-Centrally Cleared Derivatives.

24. FINRA staff's review of the off balance sheet schedule that was filed as of June 30, 2013, by all carrying and clearing members identified 47 members that reported TBA balances as of that date. A review of TRACE data for the one year period October 2012 through September 2013 showed a daily average number of transactions in Covered Agency Securities of 8,276 with an average total daily dollar volume of $192 billion. One hundred sixty-four member members reported good delivery TBA transactions during this period. The category of securities with the largest number of members reporting, at 543, is agency CMOs with a settlement date greater than three business days from trade date, where there was a daily average number of trades reported of 181 during this one year period with an average original face amount of $1,992,000.