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SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
Form 19b-4

File No.* SR - 2015 - * 036
Amendment No. (req. for Amendments *)

Filing by Financial Industry Regulatory Authority

Pursuant to Rule 19b-4 under the Securities Exchange Act of 1934

Initial *	Amendment *	Withdrawal	Section 19(b)(2) *	Section 19(b)(3)(A) *	Section 19(b)(3)(B) *
☑	☐	☐	☑	☐	☐

Rule

☐ 19b-4(f)(1) ☐ 19b-4(f)(4)
☐ 19b-4(f)(2) ☐ 19b-4(f)(5)
☐ 19b-4(f)(3) ☐ 19b-4(f)(6)

Pilot ☐

Extension of Time Period for Commission Action * ☐

Date Expires *

Notice of proposed change pursuant to the Payment, Clearing, and Settlement Act of 2010

Section 806(e)(1) * ☐

Section 806(e)(2) * ☐

Security-Based Swap Submission pursuant to the Securities Exchange Act of 1934

Section 3C(b)(2) * ☐

Exhibit 2 Sent As Paper Document ☐

Exhibit 3 Sent As Paper Document ☐

Description

Provide a brief description of the action (limit 250 characters, required when Initial is checked *).

Proposed Rule Change to Amend FINRA Rule 4210 (Margin Requirements) to Establish Margin Requirements for the TBA Market

Contact Information

Provide the name, telephone number, and e-mail address of the person on the staff of the self-regulatory organization prepared to respond to questions and comments on the action.

First Name * Adam Last Name * Arkel
Title * Associate General Counsel
E-mail * adam.arkel@finra.org
Telephone * (202) 728-6961 Fax (202) 728-8264

Signature

Pursuant to the requirements of the Securities Exchange Act of 1934,

has duly caused this filing to be signed on its behalf by the undersigned thereunto duly authorized.

Date 10/06/2015
By Patrice Gliniecki
(Name *)

(Title *)
Senior Vice President and Deputy General Counsel

NOTE: Clicking the button at right will digitally sign and lock this form. A digital signature is as legally binding as a physical signature, and once signed, this form cannot be changed.

Patrice Gliniecki,

Required fields are shown with yellow backgrounds and asterisks.

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

For complete Form 19b-4 instructions please refer to the EFFS website.

Form 19b-4 Information * Add Remove View	The self-regulatory organization must provide all required information, presented in a clear and comprehensible manner, to enable the public to provide meaningful comment on the proposal and for the Commission to determine whether the proposal is consistent with the Act and applicable rules and regulations under the Act.
Exhibit 1 - Notice of Proposed Rule Change * Add Remove View	The Notice section of this Form 19b-4 must comply with the guidelines for publication in the Federal Register as well as any requirements for electronic filing as published by the Commission (if applicable). The Office of the Federal Register (OFR) offers guidance on Federal Register publication requirements in the Federal Register Document Drafting Handbook, October 1998 Revision. For example, all references to the federal securities laws must include the corresponding cite to the United States Code in a footnote. All references to SEC rules must include the corresponding cite to the Code of Federal Regulations in a footnote. All references to Securities Exchange Act Releases must include the release number, release date, Federal Register cite, Federal Register date, and corresponding file number (e.g., SR-[SRO]-xx-xx). A material failure to comply with these guidelines will result in the proposed rule change being deemed not properly filed. See also Rule 0-3 under the Act (17 CFR 240.0-3)
Exhibit 1A- Notice of Proposed Rule Change, Security-Based Swap Submission, or Advance Notice by Clearing Agencies * Add Remove View	The Notice section of this Form 19b-4 must comply with the guidelines for publication in the Federal Register as well as any requirements for electronic filing as published by the Commission (if applicable). The Office of the Federal Register (OFR) offers guidance on Federal Register publication requirements in the Federal Register Document Drafting Handbook, October 1998 Revision. For example, all references to the federal securities laws must include the corresponding cite to the United States Code in a footnote. All references to SEC rules must include the corresponding cite to the Code of Federal Regulations in a footnote. All references to Securities Exchange Act Releases must include the release number, release date, Federal Register cite, Federal Register date, and corresponding file number (e.g., SR-[SRO]-xx-xx). A material failure to comply with these guidelines will result in the proposed rule change, security-based swap submission, or advance notice being deemed not properly filed. See also Rule 0-3 under the Act (17 CFR 240.0-3)
Exhibit 2 - Notices, Written Comments, Transcripts, Other Communications Add Remove View Exhibit Sent As Paper Document ☐	Copies of notices, written comments, transcripts, other communications. If such documents cannot be filed electronically in accordance with Instruction F, they shall be filed in accordance with Instruction G.
Exhibit 3 - Form, Report, or Questionnaire Add Remove View Exhibit Sent As Paper Document ☐	Copies of any form, report, or questionnaire that the self-regulatory organization proposes to use to help implement or operate the proposed rule change, or that is referred to by the proposed rule change.
Exhibit 4 - Marked Copies Add Remove View	The full text shall be marked, in any convenient manner, to indicate additions to and deletions from the immediately preceding filing. The purpose of Exhibit 4 is to permit the staff to identify immediately the changes made from the text of the rule with which it has been working.
Exhibit 5 - Proposed Rule Text Add Remove View	The self-regulatory organization may choose to attach as Exhibit 5 proposed changes to rule text in place of providing it in Item I and which may otherwise be more easily readable if provided separately from Form 19b-4. Exhibit 5 shall be considered part of the proposed rule change.
Partial Amendment Add Remove View	If the self-regulatory organization is amending only part of the text of a lengthy proposed rule change, it may, with the Commission's permission, file only those portions of the text of the proposed rule change in which changes are being made if the filing (i.e. partial amendment) is clearly understandable on its face. Such partial amendment shall be clearly identified and marked to show deletions and additions.

1. Text of the Proposed Rule Change

(a) Pursuant to the provisions of Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act," "SEA" or "Exchange Act"),[1] Financial Industry Regulatory Authority, Inc. ("FINRA") is filing with the Securities and Exchange Commission ("SEC" or "Commission") a proposed rule change to amend FINRA Rule 4210 (Margin Requirements) to establish margin requirements for (1) To Be Announced ("TBA") transactions, inclusive of adjustable rate mortgage ("ARM") transactions, (2) Specified Pool Transactions, and (3) transactions in Collateralized Mortgage Obligations ("CMOs"), issued in conformity with a program of an agency or Government-Sponsored Enterprise ("GSE"), with forward settlement dates, as further defined herein (collectively, "Covered Agency Transactions," also referred to, for purposes of this filing, as the "TBA market"). The proposed rule change redesignates current paragraph (e)(2)(H) of FINRA Rule 4210 as new paragraph (e)(2)(I), adds new paragraph (e)(2)(H), makes conforming revisions to paragraphs (a)(13)(B)(i), (e)(2)(F), (e)(2)(G), (e)(2)(I), as redesignated by the rule change, and (f)(6), and adds to the rule new Supplementary Materials .02 through .05.

The text of the proposed rule change is attached as Exhibit 5.

(b) Not applicable.

(c) Not applicable.

2. Procedures of the Self-Regulatory Organization

At its meeting on July 10, 2014, the FINRA Board of Governors authorized the filing of the proposed rule change with the SEC. No other action by FINRA is necessary

[1] 15 U.S.C. 78s(b)(1).

for the filing of the proposed rule change.

If the Commission approves the proposed rule change, FINRA will announce the effective date of the proposed rule change in a Regulatory Notice to be published no later than 60 days following Commission approval. The effective date will be no later than 180 days following publication of the Regulatory Notice announcing Commission approval.

3. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

(a) Purpose

FINRA is proposing amendments to FINRA Rule 4210 (Margin Requirements) to establish requirements for (1) TBA transactions,[2] inclusive of ARM transactions, (2) Specified Pool Transactions,[3] and (3) transactions in CMOs,[4] issued in conformity with a

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2 FINRA Rule 6710(u) defines "TBA" to mean a transaction in an Agency Pass-Through Mortgage-Backed Security ("MBS") or a Small Business Administration ("SBA")-Backed Asset-Backed Security ("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. Agency Pass-Through MBS and SBA-Backed ABS are defined under FINRA Rule 6710(v) and FINRA Rule 6710(bb), respectively. The term "Time of Execution" is defined under FINRA Rule 6710(d).

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

4 FINRA Rule 6710(dd) defines CMO to mean a type of Securitized Product backed by Agency Pass-Through MBS, mortgage loans, certificates backed by project loans or construction loans, other types of MBS or assets derivative of MBS, structured in multiple classes or tranches with each class or tranche entitled to receive distributions of principal or interest according to the requirements adopted for the specific class or tranche, and includes a real estate mortgage investment conduit ("REMIC").

program of an agency[5] or GSE,[6] with forward settlement dates, as further defined herein[7] (collectively, "Covered Agency Transactions," also referred to, for purposes of this filing, as the "TBA market").

Most trading of agency and GSE MBS takes place in the TBA market, which is characterized by transactions with forward settlements as long as several months past the trade date.[8] The agency and GSE MBS market is one of the largest fixed income markets, with approximately $5 trillion of securities outstanding and approximately $750 billion to $1.5 trillion in gross unsettled and unmargined dealer to customer

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5 FINRA Rule 6710(k) defines "agency" to mean a United States executive agency as defined in 5 U.S.C. 105 that is authorized to issue debt directly or through a related entity, such as a government corporation, or to guarantee the repayment of principal or interest of a debt security issued by another entity. The term excludes the U.S. Department of the Treasury in the exercise of its authority to issue U.S. Treasury Securities as defined under FINRA Rule 6710(p). Under 5 U.S.C. 105, the term "executive agency" is defined to mean an "Executive department, a Government corporation, and an independent establishment."

6 FINRA Rule 6710(n) defines GSE to have the meaning set forth in 2 U.S.C. 622(8). Under 2 U.S.C. 622(8), a GSE is defined, in part, to mean a corporate entity created by a law of the United States that has a Federal charter authorized by law, is privately owned, is under the direction of a board of directors, a majority of which is elected by private owners, and, among other things, is a financial institution with power to make loans or loan guarantees for limited purposes such as to provide credit for specific borrowers or one sector and raise funds by borrowing (which does not carry the full faith and credit of the Federal Government) or to guarantee the debt of others in unlimited amounts.

7 See Section A.1 infra.

8 See, e.g., James Vickery & Joshua Wright, TBA Trading and Liquidity in the Agency MBS Market, Federal Reserve Bank of New York ("FRBNY") Economic Policy Review, May 2013, available at: <http://www.newyorkfed.org/ research/epr/2013/1212vick.pdf>; see also SEC's Staff Report, Enhancing Disclosure in the Mortgage-Backed Securities Markets, January 2003, available at: <http://www.sec.gov/news/studies/ mortgagebacked.htm#footbody_36>.

transactions.[9]

Historically, the TBA market is one of the few markets where a significant portion of activity is unmargined, thereby creating a potential risk arising from counterparty exposure. Futures markets, for example, require the posting of initial margin for new positions and, for open positions, maintenance and mark to market (also referred to as “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. With a view to this gap between the TBA market versus other markets, the TMPG recommended standards (the “TMPG best practices”) regarding the margining of forward-settling agency MBS transactions.[10] The TMPG Report noted that, to the extent uncleared transactions in the TBA market remain unmargined, these transactions “can pose significant counterparty risk to individual market participants” and that “the market’s sheer size . . . raises systemic concerns.”[11] The TMPG Report cautioned that defaults in this 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 clearing counterparty], losses could nonetheless be costly and destabilizing.

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9 See Treasury Market Practices Group (“TMPG”), Margining in Agency MBS Trading, November 2012, available at: <http://www.newyorkfed.org/tmpg/margining_tmpg_11142012.pdf> (the “TMPG Report”). The TMPG is a group of market professionals that participate in the TBA market and is sponsored by the FRBNY.

10 See TMPG, Best Practices for Treasury, Agency, Debt, and Agency Mortgage-Backed Securities Markets, revised April 4, 2014, available at: <http://www.newyorkfed.org/tmpg/bestpractices_040414.pdf>.

11 See TMPG Report.

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."[12]

The TMPG best practices are recommendations and as such currently are not rule requirements.[13] Unsecured credit exposures that exist in the TBA market today can lead to financial losses by dealers. Permitting counterparties to participate in the TBA market without posting margin can facilitate increased leverage by customers, thereby potentially posing a risk to the dealer extending credit and to the marketplace as a whole. Further, FINRA's present requirements do not address the TBA market generally.[14] 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 for the TBA market generally that will extend responsible practices to members that participate in this market.

Accordingly, to establish margin requirements for Covered Agency Transactions, FINRA is proposing to redesignate current paragraph (e)(2)(H) of Rule 4210 as new paragraph (e)(2)(I), to add new paragraph (e)(2)(H) to Rule 4210, to make conforming revisions to paragraphs (a)(13)(B)(i), (e)(2)(F), (e)(2)(G), (e)(2)(I), as redesignated by the

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12 See note 11 supra.

13 Absent the establishment of a rule requirement, member participants have made progress in adopting the TMPG best practices. However, full adoption will take time and in the interim would leave firms at risk.

14 See Interpretations /01 through /08 of FINRA Rule 4210(e)(2)(F), available at: <http://www.finra.org/web/groups/industry/@ip/@reg/@rules/documents/industry/p122203.pdf>. 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.

rule change, and (f)(6),[15] and to add to the rule new Supplementary Materials .02 through .05. The proposed rule change is informed by the TMPG best practices. Further, the products the proposed amendments cover are intended to be congruent with those covered by the TMPG best practices and related updates that the TMPG has released.[16] FINRA sought comment on the proposal in a Regulatory Notice (the "Notice").[17] As discussed further in Item 5 of this filing, commenters expressed concerns that the proposal would unnecessarily impede accustomed patterns of business activity in the TBA market, especially for smaller customers. In considering the comments, FINRA has engaged in discussions with industry participants and other regulators, including staff of the SEC and the FRBNY. In addition, as discussed in Item 4, FINRA has engaged in analysis of the potential economic impact of the proposal. As a result, FINRA has revised the proposal as published in the Notice to ameliorate its impact on business

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15 Paragraph (e)(2) of Rule 4210, broadly, addresses margin requirements as to exempted securities, non-equity securities and baskets. As discussed further below, paragraphs (e)(2)(F) and (e)(2)(G), in combination, address specified transactions involving exempted securities, mortgage related securities, specified foreign sovereign debt securities, and investment grade debt securities. Redesignated paragraph (e)(2)(I) of the rule sets forth specified limits on net capital deductions. Paragraph (f)(6) addresses the time within which margin or mark to market must be obtained. Paragraph (a)(13)(B)(i) addresses the net worth and financial assets requirements of persons that are exempt accounts for purposes of Rule 4210.

16 See, e.g., TMPG, Frequently Asked Questions: Margining Agency MBS Transactions, June 13, 2014, available at: <http://www.newyorkfed.org/tmpg/marginingfaq06132014.pdf >; TMPG Releases Updates to Agency MBS Margining Recommendation, March 27, 2013, available at: <http://www.newyorkfed.org/tmpg/Agency%20MBS%20margining%20public%20announcement%2003-27-2013.pdf>.

17 Regulatory Notice 14-02 (January 2014) (Margin Requirements: FINRA Requests Comment on Proposed Amendments to FINRA Rule 4210 for Transactions in the TBA Market).

activity and to address the concerns of smaller customers that do not pose material risk to the market as a whole, in particular those engaging in non-margined, cash account business. These revisions include among other things the establishment of an exception from the proposed margin requirements for any counterparty with gross open positions amounting to $2.5 million or less, subject to specified conditions, as well as specified exceptions to the maintenance margin requirement and modifications to the de minimis transfer provisions.

The proposed rule change, as revised in response to comment on the Notice, is set forth in further detail below.

A. Proposed FINRA Rule 4210(e)(2)(H) (Covered Agency Transactions)

The proposed rule change is intended to reach members engaging in Covered Agency Transactions with specified counterparties. The core requirements of the proposed rule change are set forth in new paragraph (e)(2)(H).

1. Definition of Covered Agency Transactions (Proposed FINRA Rule 4210(e)(2)(H)(i)c.

Proposed paragraph (e)(2)(H)(i)c. of the rule defines Covered Agency Transactions to mean:

- TBA transactions, as defined in FINRA Rule 6710(u),[18] inclusive of ARM transactions, for which the difference between the trade date and contractual settlement date is greater than one business day;[19]

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18 See note 2 supra.

19 See proposed FINRA Rule 4210(e)(2)(H)(i)c.1. in Exhibit 5.

- Specified Pool Transactions, as defined in FINRA Rule 6710(x),[20] for which the difference between the trade date and contractual settlement date is greater than one business day;[21] and
- CMOs, as defined in FINRA Rule 6710(dd),[22] issued in conformity with a program of an agency, as defined in FINRA Rule 6710(k),[23] or a GSE, as defined in FINRA Rule 6710(n),[24] for which the difference between the trade date and contractual settlement date is greater than three business days.[25]

The proposed definition of Covered Agency Transactions is largely as published in the Notice and, as discussed above, is intended to be congruent with the scope of products addressed by the TMPG best practices and related updates.[26] As further discussed in Item 5.A, FINRA has been advised by the FRBNY staff that ensuring such congruence is necessary to prevent a mismatch between FINRA standards and the TMPG best practices that could result in perverse incentives in favor of non-margined products and thereby lead to distortions in trading behavior. Further, FINRA believes that congruence of

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20 See note 3 supra.

21 See proposed FINRA Rule 4210(e)(2)(H)(i)c.2. in Exhibit 5.

22 See note 4 supra.

23 See note 5 supra.

24 See note 6 supra.

25 See proposed FINRA Rule 4210(e)(2)(H)(i)c.3. in Exhibit 5.

26 For example, the TMPG has noted that agency multifamily and project loan securities such as Freddie Mac K Certificates, Fannie Mae Delegated Underwriting and Servicing bonds, Ginnie Mae Construction Loan/Project Loan Certificates, are all within the scope of the margining practice recommendation. See note 16 supra. The proposed definition of Covered Agency Transactions would cover these types of products as they are commonly understood to the industry.

product coverage helps stabilize the market by ensuring regulatory consistency.

2. Other Key Definitions Established by the Proposed Rule Change (Proposed FINRA Rule 4210(e)(2)(H)(i))

In addition to Covered Agency Transactions, the proposed rule change establishes the following key definitions for purposes of new paragraph (e)(2)(H) of Rule 4210:

- The term "bilateral transaction" means a Covered Agency Transaction that is not cleared through a registered clearing agency as defined in paragraph (f)(2)(A)(xxviii) of Rule 4210;[27]
- The term "counterparty" means any person that enters into a Covered Agency Transaction with a member and includes a "customer" as defined in paragraph (a)(3) of Rule 4210;[28]
- The term "deficiency" means the amount of any required but uncollected maintenance margin and any required but uncollected mark to market loss;[29]
- The term "gross open position" means, with respect to Covered Agency Transactions, the amount of the absolute dollar value of all contracts entered into by a counterparty, in all CUSIPs; provided, however, that such amount shall be computed net of any settled position of the counterparty held at the member and deliverable under one or more of the counterparty's contracts

27 See proposed FINRA Rule 4210(e)(2)(H)(i)a. in Exhibit 5. FINRA Rule 4210(f)(2)(A)(xxviii) defines registered clearing agency to mean a clearing agency as defined in SEA Section 3(a)(23) that is registered with the SEC pursuant to SEA Section 17A(b)(2).

28 See proposed FINRA Rule 4210(e)(2)(H)(i)b. in Exhibit 5.

29 See proposed FINRA Rule 4210(e)(2)(H)(i)d. in Exhibit 5.

with the member and which the counterparty intends to deliver;[30]

- The term "maintenance margin" means margin equal to two percent of the contract value of the net long or net short position, by CUSIP, with the counterparty;[31]
- The term "mark to market loss" means the counterparty's loss resulting from marking a Covered Agency Transaction to the market;[32]
- The term "mortgage banker" means an entity, however organized, that engages in the business of providing real estate financing collateralized by liens on such real estate;[33]
- The term "round robin" trade means any transaction or transactions resulting in equal and offsetting positions by one customer with two separate dealers for the purpose of eliminating a turnaround delivery obligation by the customer;[34] and
- The term "standby" means contracts that are put options that trade OTC, as defined in paragraph (f)(2)(A)(xxvii) of Rule 4210, with initial and final confirmation procedures similar to those on forward transactions.[35]

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30 See proposed FINRA Rule 4210(e)(2)(H)(i)e. in Exhibit 5.

31 See proposed FINRA Rule 4210(e)(2)(H)(i)f. in Exhibit 5.

32 See proposed FINRA Rule 4210(e)(2)(H)(i)g. in Exhibit 5.

33 See proposed FINRA Rule 4210(e)(2)(H)(i)h. in Exhibit 5.

34 See proposed FINRA Rule 4210(e)(2)(H)(i)i. in Exhibit 5.

35 See proposed FINRA Rule 4210(e)(2)(H)(i)j. in Exhibit 5. FINRA Rule 4210(f)(2)(A)(xxvii) defines the term "OTC" as used with reference to a call or put option contract to mean an over-the-counter option contract that is not traded

3. Requirements for Covered Agency Transactions (Proposed FINRA Rule 4210(e)(2)(H)(ii))

The specific requirements that would apply to Covered Agency Transactions are set forth in paragraph (e)(2)(H)(ii). These requirements address the types of counterparties that are subject to the rule, risk limit determinations, specified exceptions from the proposed margin requirements, transactions with exempt accounts,[36] transactions with non-exempt accounts, the handling of de minimis transfer amounts, and the treatment of standbys.

- Counterparties Subject to the Rule

Paragraph (e)(2)(H)(ii)a. of the rule provides that all Covered Agency Transactions with any counterparty, regardless of the type of account to which booked,

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on a national securities exchange and is issued and guaranteed by the carrying broker-dealer. The term does not include an Options Clearing Corporation ("OCC") Cleared OTC Option as defined in FINRA Rule 2360 (Options).

36 The term "exempt account" is defined under FINRA Rule 4210(a)(13). Broadly, an exempt account means a FINRA member, non-FINRA member registered broker-dealer, account that is a "designated account" under FINRA Rule 4210(a)(4) (specifically, a bank as defined under SEA Section 3(a)(6), a savings association as defined under Section 3(b) of the Federal Deposit Insurance Act, the deposits of which are insured by the Federal Deposit Insurance Corporation, an insurance company as defined under Section 2(a)(17) of the Investment Company Act, an investment company registered with the Commission under the Investment Company Act, a state or political subdivision thereof, or a pension plan or profit sharing plan subject to the Employee Retirement Income Security Act or of an agency of the United States or of a state or political subdivision thereof), and any person that has a net worth of at least $45 million and financial assets of at least $40 million for purposes of paragraphs (e)(2)(F) and (e)(2)(G) of the rule, as set forth under paragraph (a)(13)(B)(i) of Rule 4210, and meets specified conditions as set forth under paragraph (a)(13)(B)(ii). FINRA is proposing a conforming revision to paragraph (a)(13)(B)(i) so that the phrase "for purposes of paragraphs (e)(2)(F) and (e)(2)(G)" would read "for purposes of paragraphs (e)(2)(F), (e)(2)(G) and (e)(2)(H)." See proposed FINRA Rule 4210(a)(13)(B)(i) in Exhibit 5.

are subject to the provisions of paragraph (e)(2)(H) of the rule. However, paragraph (e)(2)(H)(ii)a.1. of the rule provides that with respect to Covered Agency Transactions with any counterparty that is a Federal banking agency, as defined in 12 U.S.C. 1813(z) under the Federal Deposit Insurance Act,[37] central bank, multinational central bank, foreign sovereign, multilateral development bank, or the Bank for International Settlements, a member may elect not to apply the margin requirements specified in paragraph (e)(2)(H) provided the member makes a written risk limit determination for each such counterparty that the member shall enforce pursuant to paragraph (e)(2)(H)(ii)b., as discussed below.[38]

- Risk Limits

Paragraph (e)(2)(H)(ii)b. of the rule provides that members that engage in Covered Agency Transactions with any counterparty shall make a determination in writing of a risk limit for each such counterparty that the member shall enforce.[39] The

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37 12 U.S.C. 1813(z) defines "Federal banking agency" to mean the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, or the Federal Deposit Insurance Corporation.

38 See proposed FINRA Rule 4210(e)(2)(H)(ii)a.1. in Exhibit 5. As proposed in the Notice, central banks and other similar instrumentalities of sovereign governments would be excluded from the proposed rule's application. FINRA believes that revising the proposal so members may elect not to apply the margin requirements to such entities, provided members make and enforce the specified risk limit determinations, should help provide members flexibility to manage their risk vis-à-vis the various central banks and similar entities that participate in the market. Further, FINRA believes the rule language, as revised, is more clear as to the types of entities with respect to which such election would be available. For further discussion, see Item 5.G infra.

39 FINRA has made minor revisions to the language vis-à-vis the version as published in the Notice to clarify that the member must make, and enforce, a written risk limit determination for each counterparty with which the member engages in Covered Agency Transactions.

rule provides that the risk limit determination shall be made by a designated credit risk officer or credit risk committee in accordance with the member's written risk policies and procedures. Further, in connection with risk limit determinations, the proposed rule establishes new Supplementary Material .05, which, in response to comment, FINRA has revised vis-à-vis the version published in the Notice.[40] The new Supplementary Material provides that, for purposes of any risk limit determination pursuant to paragraphs (e)(2)(F), (e)(2)(G)[41] or (e)(2)(H) of the rule:

- If a member engages in transactions with advisory clients of a registered investment adviser, the member may elect to make the risk limit determination at the investment adviser level, except with respect to any account or group of commonly controlled accounts whose assets managed by that investment adviser constitute more than 10 percent of the investment adviser's regulatory assets under management as reported on the investment adviser's most recent Form ADV;[42]
- Members of limited size and resources that do not have a credit risk

40 FINRA believes the proposed requirement is necessary because risk limit determinations help to ensure that the member is properly monitoring its risk. FINRA believes the Supplementary Material, as revised, responds to commenter concerns by, among other things, permitting members flexibility to make the required risk limit determinations without imposing burdens at the sub-account level. For further discussion of Supplementary Material .05, as revised vis-à-vis the version published in the Notice, see Item 5.D infra.

41 As discussed further below, FINRA is proposing as part of this rule change revisions to paragraphs (e)(2)(F) and (e)(2)(G) of Rule 4210 to align those paragraphs with new paragraph (e)(2)(H) and otherwise make clarifying changes in light of the rule change.

42 See proposed FINRA Rule 4210.05(a)(1) in Exhibit 5.

officer or credit risk committee may designate an appropriately registered principal to make the risk limit determinations;[43]

- o The member may base the risk limit determination on consideration of all products involved in the member's business with the counterparty, provided the member makes a daily record of the counterparty's risk limit usage;[44] and
- o A member shall consider whether the margin required pursuant to the rule is adequate with respect to a particular counterparty account or all its counterparty accounts and, where appropriate, increase such requirements.[45]

- Exceptions from the Proposed Margin Requirements: (1) Registered Clearing Agencies; (2) Gross Open Positions of $2.5 Million or Less in Aggregate

Paragraph (e)(2)(H)(ii)c. provides that the margin requirements specified in paragraph (e)(2)(H) of the rule shall not apply to:

- o Covered Agency Transactions that are cleared through a registered clearing agency, as defined in FINRA Rule 4210(f)(2)(A)(xxviii),[46] and are subject to the margin requirements of that clearing agency; and
- o any counterparty that has gross open positions in Covered Agency Transactions with the member amounting to $2.5 million or less in

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43 See proposed FINRA Rule 4210.05(a)(2) in Exhibit 5.

44 See proposed FINRA Rule 4210.05(a)(3) in Exhibit 5.

45 See proposed FINRA Rule 4210.05(a)(4) in Exhibit 5.

46 See note 27 supra.

> aggregate, if the original contractual settlement for all such transactions is in the month of the trade date for such transactions or in the month succeeding the trade date for such transactions and the counterparty regularly settles its Covered Agency Transactions on a Delivery Versus Payment ("DVP") basis or for cash; provided, however, that such exception from the margin requirements shall not apply to a counterparty that, in its transactions with the member, engages in dollar rolls, as defined in FINRA Rule 6710(z),[47] or round robin trades, or that uses other financing techniques for its Covered Agency Transactions.

As discussed further in Items 4 and 5 of this filing, FINRA is establishing the $2.5 million per counterparty exception to address commenter concern that the scope of Covered Agency Transactions subject to the proposed margin requirements would unnecessarily constrain non-risky business activity of market participants or otherwise unnecessarily alter participants' trading decisions. FINRA believes that transactions that fall within the proposed amount and that meet the specified conditions do not pose systemic risk. Further, many of such transactions involve smaller counterparties that do not give rise to risk to the firm. Accordingly, FINRA believes it is appropriate to establish the exception.[48]

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[47] FINRA Rule 6710(z) defines "dollar roll" to mean a simultaneous sale and purchase of an Agency Pass-Through MBS for different settlement dates, where the initial seller agrees to take delivery, upon settlement of the re-purchase transaction, of the same or substantially similar securities.

[48] FINRA notes, however, that it is revising the provisions with respect to limits on net capital deductions as set forth in redesignated paragraph (e)(2)(I) so that amounts excepted pursuant to the $2.5 million exclusion must be included toward

- Transactions with Exempt Accounts

Paragraph (e)(2)(H)(ii)d. of the rule provides that, on any net long or net short position, by CUSIP, resulting from bilateral transactions with a counterparty that is an exempt account, no maintenance margin shall be required.[49] However, the rule provides that such transactions must be marked to the market daily and the member must collect any net mark to market loss, unless otherwise provided under paragraph (e)(2)(H)(ii)f. of the rule.[50] The rule provides that if the mark to market loss is not satisfied by the close of business on the next business day after the business day on which the mark to market loss arises, the member shall be required to deduct the amount of the mark to market loss from net capital as provided in SEA Rule 15c3-1 until such time the mark to market loss

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the concentration thresholds as set forth under new paragraph (e)(2)(I). See Section C infra. FINRA believes that this is appropriate in the interest of limiting excessive risk. Further, FINRA notes that the proposed exceptions under paragraph (e)(2)(H)(ii)c. are exceptions to the margin requirements under paragraph (e)(2)(H). The requirement to determine a risk limit pursuant to paragraph (e)(2)(H)(ii)b. would apply.

49 The proposed rule change adds to FINRA Rule 4210 new Supplementary Material .04, which provides that, for purposes of paragraph (e)(2)(H) of the rule, the determination of whether an account qualifies as an exempt account must be based upon the beneficial ownership of the account. The rule provides that sub-accounts managed by an investment adviser, where the beneficial owner is other than the investment adviser, must be margined individually. As discussed further in Item 5.E, commenters expressed concerns regarding the proposed requirement. Supplementary Material .04 as proposed in this filing is as proposed in the Notice, as FINRA believes individual margining is fundamental sound practice. However, in response to comment, and as further discussed in Item 5.D, FINRA has revised the proposed rule change to provide that risk limit determinations may be made at the investment adviser level, subject to specified conditions. See discussion of Risk Limits supra.

50 As discussed further below, paragraph (e)(2)(H)(ii)f. addresses the treatment of de minimis transfer amounts.

is satisfied.[51] The rule requires that if such mark to market loss is not satisfied within five business days from the date the loss was created, the member must promptly liquidate positions to satisfy the mark to market loss, unless FINRA has specifically granted the member additional time.[52] Under the rule, members may treat mortgage bankers that use Covered Agency Transactions to hedge their pipeline of mortgage commitments as exempt accounts for purposes of paragraph (e)(2)(H) of this Rule.[53]

- Transactions with Non-Exempt Accounts

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51 FINRA has made minor revisions to the language as to timing of the specified deduction so as to better align with corresponding provisions under FINRA Rule 4210(g)(10)(A) in the context of portfolio margining.

52 See note 55 infra. Further, to conform with the proposed rule change, FINRA is revising paragraph (f)(6) of FINRA Rule 4210, which currently permits up to 15 business days for obtaining the amount of margin or mark to market, unless FINRA has specifically granted the member additional time. As revised, the phrase "other than that required under paragraph (e)(2)(H) of this Rule" would be added to paragraph (f)(6) so as to accommodate the five days specified under the proposed rule change. As discussed further in Item 5.H of this filing, commenters expressed concern that the specified five day period, both as to exempt accounts under paragraph (e)(2)(H)(ii)d., and as to non-exempt accounts under paragraph (e)(2)(H)(ii)e., is too aggressive. FINRA believes the five day period is appropriate in view of the potential counterparty risk in the TBA market. The rule makes express allowance for additional time, which FINRA notes is consistent with longstanding practice under current FINRA Rule 4210(f)(6).

53 The proposed rule change adds to Rule 4210 new Supplementary Material .02, which provides that for purposes of paragraph (e)(2)(H)(ii)d. of the rule, members must adopt written procedures to monitor the mortgage banker's pipeline of mortgage loan commitments to assess whether the Covered Agency Transactions are being used for hedging purposes. This provision is largely as proposed in the Notice. Discussion of the proposed rule's potential impact on mortgage bankers is discussed further in Item 4. The proposed requirement is appropriate to ensure that, if a mortgage banker is permitted exempt account treatment, the member has conducted sufficient due diligence to determine that the mortgage banker is hedging its pipeline of mortgage production. In this regard, FINRA notes that the current Interpretations under Rule 4210 already contemplate that members evaluate the loan servicing portfolios of counterparties that are being treated as exempt accounts. See Interpretation /02 of FINRA Rule 4210(e)(2)(F).

Paragraph (e)(2)(H)(ii)e. of the rule provides that, on any net long or net short position, by CUSIP, resulting from bilateral transactions with a counterparty that is not an exempt account, maintenance margin,[54] plus any net mark to market loss on such transactions, shall be required margin, and the member shall collect the deficiency, as defined in paragraph (e)(2)(H)(i)d. of the rule, unless otherwise provided under paragraph (e)(2)(H)(ii)f. of the rule. The rule provides that if the deficiency is not satisfied by the close of business on the next business day after the business day on which the deficiency arises, the member shall be required to deduct the amount of the deficiency from net capital as provided in SEA Rule 15c3-1 until such time the deficiency is satisfied.[55] Further, the rule provides that if such deficiency is not satisfied within five business days from the date the deficiency was created, the member shall promptly liquidate positions to satisfy the deficiency, unless FINRA has specifically granted the member additional time.[56]

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54 As discussed above, the proposed definition of "maintenance margin" specifies margin equal to two percent of the contract value of the net long or net short position. See proposed FINRA Rule 4210(e)(2)(H)(i)f. in Exhibit 5.

55 The proposed rule change adds to FINRA Rule 4210 new Supplementary Material .03, which provides that, for purposes of paragraph (e)(2)(H) of the rule, to the extent a mark to market loss or deficiency is cured by subsequent market movements prior to the time the margin call must be met, the margin call need not be met and the position need not be liquidated; provided, however, if the mark to market loss or deficiency is not satisfied by the close of business on the next business day after the business day on which the mark to market loss or deficiency arises, the member shall be required to deduct the amount of the mark to market loss or deficiency from net capital as provided in SEA Rule 15c3-1 until such time the mark to market loss or deficiency is satisfied. See note 51 supra. FINRA believes that the proposed requirement should help provide clarity in situations where subsequent market movements cure the mark to market loss or deficiency.

56 See notes 52 and 55 supra.

As discussed further in Item 4 and Item 5 of this filing, commenters expressed concern regarding the potential impact of the proposed maintenance margin requirement and its implications for non-exempt accounts versus exempt accounts. FINRA believes that the maintenance margin requirement is appropriate because it aligns with the potential risk as to non-exempt accounts engaging in Covered Agency Transactions and the specified two percent amount is consistent with other measures in this area. By the same token, to tailor the requirement more specifically to the potential risk, and to ameliorate potential burdens on market participants, FINRA has revised the proposed maintenance margin requirement vis-à-vis the version published in the Notice. Specifically, as revised, the rule provides that no maintenance margin is required if the original contractual settlement for the Covered Agency Transaction is in the month of the trade date for such transaction or in the month succeeding the trade date for such transaction and the customer regularly settles its Covered Agency Transactions on a DVP basis or for cash; provided, however, that such exception from the required maintenance margin shall not apply to a non-exempt account that, in its transactions with the member, engages in dollar rolls, as defined in FINRA Rule 6710(z), or round robin trades, as defined in proposed FINRA Rule 4210(e)(2)(H)(i)i., or that uses other financing techniques for its Covered Agency Transactions.[57]

- De Minimis Transfer Amounts

Paragraph (e)(2)(H)(ii)f. of the rule provides that any deficiency, as set forth in paragraph (e)(2)(H)(ii)e. of the rule, or mark to market losses, as set forth in paragraph (e)(2)(H)(ii)d. of the rule, with a single counterparty shall not give rise to any margin

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57 See Item 4 and Item 5.B for further discussion of the potential economic impact of the proposed requirement and comments received in response to the Notice.

requirement, and as such need not be collected or charged to net capital, if the aggregate of such amounts with such counterparty does not exceed $250,000 ("the de minimis transfer amount"). The rule provides that the full amount of the sum of the required maintenance margin and any mark to market loss must be collected when such sum exceeds the de minimis transfer amount.

FINRA has revised the proposed de minimis transfer provisions vis-à-vis the proposal as published in the Notice. As discussed in the Notice, FINRA intends the de minimis transfer provisions to reduce potential operational burdens on members. However, some commenters expressed concerns that the provisions could among other things result in imposing forced capital charges.[58] FINRA believes that the proposal, as revised, should help clarify that any deficiency or mark to market loss, as set forth under the proposed rule, with a single counterparty shall not give rise to any margin requirement, and as such need not be collected or charged to net capital, if the aggregate of such amounts with such counterparty does not exceed $250,000. FINRA believes this is appropriate because the de minimis transfer amount, by permitting members to avoid a capital charge that would otherwise be required absent the provision, is designed to help prevent smaller members from being subject to a potential competitive disadvantage and to maintain a level playing field for all members. FINRA does not believe that it is necessary for systemic safety to impose a capital charge for amounts within the specified thresholds. However, FINRA believes it is necessary to set a parameter for limiting excessive risk and as such is retaining the $250,000 amount as originally proposed in the

58 See Item 5.C for further discussion.

Notice.[59]

- Unrealized Profits; Standbys

Paragraph (e)(2)(H)(ii)g. of the rule provides that unrealized profits in one Covered Agency Transaction position may offset losses from other Covered Agency Transaction positions in the same counterparty's account and the amount of net unrealized profits may be used to reduce margin requirements. With respect to standbys, only profits (in-the-money amounts), if any, on long standbys shall be recognized. The proposed language is largely as proposed in the Notice.

B. Conforming Amendments to FINRA Rule 4210(e)(2)(F) (Transactions With Exempt Accounts Involving Certain "Good Faith" Securities) and FINRA Rule 4210(e)(2)(G) (Transactions With Exempt Accounts Involving Highly Rated Foreign Sovereign Debt Securities and Investment Grade Debt Securities)

The proposed rule change makes a number of revisions to paragraphs (e)(2)(F) and (e)(2)(G) of FINRA Rule 4210 in the interest of clarifying the rule's structure and otherwise conforming the rule in light of the proposed revisions to new paragraph (e)(2)(H) as discussed above:

- The proposed rule change revises the opening sentence of paragraph (e)(2)(F) to clarify that the paragraph's scope does not apply to Covered Agency Transactions as defined pursuant to new paragraph (e)(2)(H). Accordingly, as amended, paragraph (e)(2)(F) states: "Other than for Covered Agency Transactions as defined in paragraph (e)(2)(H) of this Rule . . ." FINRA

59 In this regard, FINRA notes further that it is revising the provisions with respect to limits on net capital deductions as set forth in redesignated paragraph (e)(2)(I) so that the de minimis transfer amount, though it would not give rise to any margin requirement, must be included toward the concentration thresholds as set forth under the rule. See Section C infra.

believes that this clarification will help demarcate the treatment of products subject to paragraph (e)(2)(F) versus new paragraph (e)(2)(H). For similar reasons, the proposed rule change revises paragraph (e)(2)(G) to clarify that the paragraph's scope does not apply to a position subject to new paragraph (e)(2)(H) in addition to paragraph (e)(2)(F) as the paragraph currently states. As amended, the parenthetical in the opening sentence of the paragraph states: "([O]ther than a position subject to paragraph (e)(2)(F) or (e)(2)(H) of this Rule)."

- Current, pre-revision paragraph (e)(2)(H)(i) provides that members must maintain a written risk analysis methodology for assessing the amount of credit extended to exempt accounts pursuant to paragraphs (e)(2)(F) and (e)(2)(G) of the rule which shall be made available to FINRA upon request. The proposed rule change places this language in paragraphs (e)(2)(F) and (e)(2)(G) and deletes it from its current location. Accordingly, FINRA proposes to move to paragraphs (e)(2)(F) and (e)(2)(G): "Members shall maintain a written risk analysis methodology for assessing the amount of credit extended to exempt accounts pursuant to [this paragraph], which shall be made available to FINRA upon request." Further, FINRA proposes to add to each: "The risk limit determination shall be made by a designated credit risk officer or credit risk committee in accordance with the member's written risk policies and procedures."[60] FINRA believes this amendment makes the risk limit determination language in paragraphs (e)(2)(F) and (e)(2)(G) more

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60 See proposed FINRA Rule 4210(e)(2)(F) and Rule 4210(e)(2)(G) in Exhibit 5.

congruent with the corresponding language proposed for new paragraph (e)(2)(H) of the rule.

- The proposed rule change revises the references in paragraphs (e)(2)(F) and (e)(2)(G) to the limits on net capital deductions as set forth in current paragraph (e)(2)(H) to read “paragraph (e)(2)(I)” in conformity with that paragraph’s redesignation pursuant to the rule change.

C. Redesignated Paragraph (e)(2)(I) (Limits on Net Capital Deductions)

Under current paragraph (e)(2)(H) of FINRA Rule 4210, in brief, a member must provide prompt written notice to FINRA and is prohibited from entering into any new transactions that could increase the member’s specified credit exposure if net capital deductions taken by the member as a result of marked to the market losses incurred under paragraphs (e)(2)(F) and (e)(2)(G), over a five day business period, exceed: (1) for a single account or group of commonly controlled accounts, five percent of the member’s tentative net capital (as defined in SEA Rule 15c3-1); or (2) for all accounts combined, 25 percent of the member’s tentative net capital (again, as defined in SEA Rule 15c3-1). As discussed earlier, the proposed rule change redesignates current paragraph (e)(2)(H) of the rule as paragraph (e)(2)(I), deletes current paragraph (e)(2)(H)(i), and makes conforming revisions to paragraph (e)(2)(I), as redesignated, for the purpose of clarifying that the provisions of that paragraph are meant to include Covered Agency Transactions as set forth in new paragraph (e)(2)(H). In addition, the proposed rule change clarifies that de minimis transfer amounts must be included toward the five percent and 25 percent thresholds as specified in the rule, as well as amounts pursuant to the specified exception under paragraph (e)(2)(H) for gross open positions of $2.5 million or less in aggregate.[61]

Accordingly, as revised by the rule change, redesignated paragraph (e)(2)(I) of the rule provides that, in the event that the net capital deductions taken by a member as a result of deficiencies or marked to the market losses incurred under paragraphs (e)(2)(F) and (e)(2)(G) of the rule (exclusive of the percentage requirements established thereunder), plus any mark to market loss as set forth under paragraph (e)(2)(H)(ii)d. of the rule and any deficiency as set forth under paragraph (e)(2)(H)(ii)e. of the rule, and inclusive of all amounts excepted from margin requirements as set forth under paragraph (e)(2)(H)(ii)c.2. of the rule or any de minimis transfer amount as set forth under paragraph (e)(2)(H)(ii)f. of the rule, exceed:

- for any one account or group of commonly controlled accounts, 5 percent of the member's tentative net capital (as such term is defined in SEA Rule 15c3-1),[62] or
- for all accounts combined, 25 percent of the member's tentative net capital (as such term is defined in SEA Rule 15c3-1),[63] and,
- such excess as calculated in paragraphs (e)(2)(I)(i)a. or b. of the rule continues to exist on the fifth business day after it was incurred,[64]

the member must give prompt written notice to FINRA and shall not enter into any new

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61 As discussed earlier, FINRA believes that inclusion of the de minimis transfer amounts and amounts pursuant to the $2.5 million per counterparty exception is appropriate in view of the rule's purpose of limiting excessive risk.

62 See proposed FINRA Rule 4210(e)(2)(I)(i)a. in Exhibit 5.

63 See proposed FINRA Rule 4210(e)(2)(I)(i)b. in Exhibit 5.

64 See proposed FINRA Rule 4210(e)(2)(I)(i)c. in Exhibit 5.

transaction(s) subject to the provisions of paragraphs (e)(2)(F), (e)(2)(G) or (e)(2)(H) of the rule that would result in an increase in the amount of such excess under, as applicable, paragraph (e)(2)(I)(i) of the rule.

As noted in Item 2 of this filing, if the Commission approves the proposed rule change, FINRA will announce the effective date of the proposed rule change in a Regulatory Notice to be published no later than 60 days following Commission approval. The effective date will be no later than 180 days following publication of the Regulatory Notice announcing Commission approval.

(b) Statutory Basis

FINRA believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,[65] which requires, among other things, that FINRA rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. FINRA believes that the proposed rule change is consistent with the Act because, by establishing margin requirements for Covered Agency Transactions (the TBA market), the proposed rule change will help to reduce the risk of loss due to counterparty failure in one of the largest fixed income markets and thereby help protect investors and the public interest by ensuring orderly and stable markets. As FINRA has noted, unsecured credit exposures that exist in the TBA market today can lead to financial losses by members. Permitting members to deal with counterparties in the TBA market without collecting margin can facilitate increased leverage by customers, thereby potentially posing a risk to FINRA members that extend credit and to the marketplace as

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[65] 15 U.S.C. 78o-3(b)(6).

a whole. FINRA believes that, 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, particularly since the financial crises of 2008 and 2009, and in light of regulatory efforts to enhance risk controls in related markets, there is a need to establish FINRA rule requirements that will extend responsible practices to all members that participate in the TBA market. In preparing this rule filing, FINRA has undertaken economic analysis of the proposed rule change's potential impact and has made revisions to the proposed rule change, vis-à-vis the version as originally published in Regulatory Notice 14-02, so as to ameliorate the proposed rule change's impact on business activity and to address the concerns of smaller customers that do not pose material risk to the market as a whole. These revisions include among other things the establishment of an exception from the proposed margin requirements for any counterparty with gross open positions amounting to $2.5 million or less, subject to specified conditions, as well as specified exceptions to the proposed maintenance margin requirement and modifications to the de minimis transfer provisions.

4. Self-Regulatory Organization's Statement on Burden on Competition

FINRA does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act. As discussed above, FINRA published Regulatory Notice 14-02 (January 2014) (the "Notice") to request comment[66] on proposed amendments to FINRA Rule 4210 to establish margin requirements for transactions in the TBA market. FINRA noted that the proposal is informed by the TMPG best practices.

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[66] All references to commenters are to commenters as listed in Exhibit 2b and as further discussed in Item 5 of this filing.

The proposed rule change aims to reduce firm exposure to counterparty credit risk stemming from unsecured credit exposure that exists in the market today. A significant portion of the TBA market is non-centrally cleared, exposing parties extending credit in a transaction to significant counterparty risk between trade and settlement dates.[67] To the extent that the proposed rule change encourages better risk management practices, the loss given default by a counterparty with substantial positions in Covered Agency Transactions should decrease.

The unmargined positions in the TBA market may also raise systemic concerns. Were one or more counterparties to default, the interconnectedness and concentration in the TBA market may lead to potentially broadening losses and the possibility of substantial disruption to financial markets and participants.

The repercussions of unmargined bilateral credit exposures were demonstrated in the Bear Stearns and Lehman Brothers failures in 2008. Since the financial crisis of 2008-09, margining regimes on bilateral credit transactions have been strengthened by regulatory bodies and adopted as a part of best practices by industry groups. For example, margining has become a widespread practice – especially after the adoption of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act)[68] – in repurchase agreements, securities lending and derivatives markets.[69] Thus,

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67 See, e.g., TMPG Recommends Margining of Agency MBS Transactions to Reduce Counterparty and Systemic Risks, November 14, 2012, available at: <http://www.newyorkfed.org/tmpg/marginambs.pdf >; see also TMPG Report.

68 Pub. L. No. 111-203, 124 Stat. 1376 (2010).

69 See Bank for International Settlements, Margin Requirements for Non-centrally Cleared Derivatives – Final Report Issued by the Basel Committee and IOSCO, September 2, 2013, available at: <http://www.bis.org/press/p130902.htm>.

the lack of mandatory margining currently between dealers and their customers in the TBA market is out of step with regulatory developments in other markets with forward settlements. To address this gap, TMPG urged implementation of its margining recommendations by the end of 2013.[70]

As discussed above, the proposed rule change would require member firms to collect, as to exempt accounts, mark to market margin and, as to non-exempt accounts, both mark to market margin and maintenance margin, as specified by the rule. Based on discussions with industry participants, FINRA expects that very few accounts would be treated as non-exempt accounts under the rule, and hence most would not be subject to the maintenance margin requirement.[71] Therefore, the economic impact assessment as set forth below is centered on the impact of the proposed mark to market margin.

A. Economic Baseline

To better understand the TBA market, FINRA analyzed data from two sources. The first dataset contains approximately 2.06 million TBA market transactions reported to TRACE by 223 broker-dealers from March 1, 2012 to July 31, 2013. Of the 2.06 million trades, approximately 1.10 million were interdealer trades, and 960,000 were

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70 See TMPG Releases Updates to Agency MBS Margining Recommendation, March 27, 2013, available at: <http://www.newyorkfed.org/tmpg/Agency%20MBS% 20margining%20public% 20announcement%2003-27-2013.pdf>.

71 As discussed above, the proposed rule permits members to treat mortgage bankers that use Covered Agency Transactions to hedge their pipeline of mortgage commitments as exempt accounts for purposes of the rule. Based on discussions with industry participants, FINRA believes that a great majority of mortgage bankers transact in the market to hedge their loans, and engage in very little speculative trading. While TRACE data do not identify the motivation for the trade to validate this statement, FINRA understands, based on discussions with market participants, that most Covered Agency Transactions will be excepted from the proposed maintenance margin requirement.

dealer-to-customer trades.[72] Approximately 26.65% of the interdealer trades and 28.87% of the dealer-to-customer trades were designated as dollar rolls, a funding mechanism in which there is a simultaneous sale and purchase of an Agency Pass-Through Mortgage-Backed Security with different settlement dates. The mean trade size was $19.33 million (the median was $19.34 million) and the median daily trading volume was $199 billion, totaling $49.3 trillion annually. The mean difference between the trade and contractual settlement date was 29.5 days (the median was 26 days).

Based on FINRA's analysis of the transactions in the TRACE dataset, market participation by broker-dealers is highly concentrated, as the top ten broker-dealers account for more than approximately 77% of the dollar trading volume in the trades analyzed. These are primarily broker-dealers affiliated with large bank holding companies and include FINRA's ten largest members. Five are members of the TMPG.[73] Non-FINRA members are not required to report transactions in TRACE.

FINRA understands that most interdealer transactions in the TBA market are subject to mark to market margin between members of the Mortgage-Backed Securities Division ("MBSD") of the Fixed Income Clearing Corporation ("FICC," a subsidiary of

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[72] FINRA understands that dealer-to-customer trades in the TRACE data include a significant volume of transactions where the broker dealer is counterparty to the FRBNY. While such trades are not directly distinguishable within the data from other dealer-to-customer trades in TRACE, the FRBNY publishes a list of its transactions available at: <http://www.newyorkfed.org/ markets/ambs/ambs_schedule.html>. Based on this public information, FINRA estimates that the FRBNY transacted in 44 of the 2,677 distinct CUSIPs reported in TRACE, and accounted for 1.63% of the overall trades in the sample. However, FRBNY trades are quite large in size, and account for, on average, 24.80% of the daily volume for those CUSIPs on the days it trades.

[73] Besides broker-dealers, TMPG members also include banks, buy-side firms, market utilities, foreign central banks, and others.

the Depository Trust & Clearing Corporation ("DTCC")), which acts as a central counterparty. Also, FINRA understands that, as of June, 2014, TMPG member firms had, on average, margining agreements with approximately 65% of their counterparties.[74] FINRA understands that these firms' activities account for approximately 70% of transactions in the TBA market, and 85% of notional trading volume. However, full adoption of mark to market margining practices by TMPG member firms is yet to be achieved. The lack of market-wide adoption of margin practices may put some market participants at a disadvantage, as they incur the costs associated with implementation of mark to market margin, while unmargined participants are able to transact at lower economic cost.

To assess the likely impact of the proposal, FINRA estimated the daily margin requirement that broker-dealers and their customers would have had to post under the proposed requirement, using transaction data in the TBA market that are available from TRACE and were made available by a major clearing broker. FINRA notes that there are several limitations to the analysis due to data availability. Among these, the data are not granular enough to contain sufficient detail on contractual settlement terms, with respect to which the proposed rule change establishes parameters for specified exceptions to apply,[75] or as to whether the trade is a specified financing trade (we note that, other than

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74 See TMPG Meeting Minutes, June 25, 2014, available at: <http://www.newyorkfed. org/tmpg/june_minutes_2014.pdf>.

75 To recap, the rule's margin requirements would not apply to any counterparty that has gross open positions in Covered Agency Transactions amounting to $2.5 million or less in aggregate, if the original contractual settlement for all such transactions is in the month of the trade date for such transactions or in the month succeeding the trade date for such transactions and the counterparty regularly settles its Covered Agency Transactions DVP or for cash, subject to specified conditions. See proposed FINRA Rule 4210(e)(2)(H)(ii)c.2. in Exhibit 5.

dollar roll trades, TRACE does not require a special code for round robin, repurchase or reverse repurchase, or financing trades), with respect to which specified exceptions under the proposal are not available.[76] Therefore, FINRA notes that it is able to make only limited inference about the current level of trading that would be subject to the specified exceptions. Moreover, unique customer identity is not available in TRACE, meaning FINRA is unable to assess the activities in individual accounts to determine which, if any, exceptions might apply.

The second dataset, containing TBA transactions, was provided to FINRA by a major clearing broker and contains 5,201 open positions as of May 30, 2014, in 375 customer accounts from ten introducing broker-dealers. These data represent 4,211 open short positions and 990 open long positions. The mean sizes for long and short positions were $2.02 million and $1.69 million, respectively, while the median open position size was $1.00 million for both long and short positions. In the sample, an account had a mean of 13.87 open positions (a median of 10) where the mean gross exposure was $24.31 million (a median of $12 million). This dataset enables FINRA to make inferences about the potential margin obligations that individual customer accounts would incur, which is not possible using TRACE, since unique customer identifications are not available. As such, these customer accounts may provide better understanding of customer, particularly mortgage banker, activity. However, the data do not identify

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[76] To recap, the $2.5 million per counterparty exception and, with respect to non-exempt accounts, the proposed relief from maintenance margin, are not available to a counterparty that, in its transactions with the member, engages in dollar rolls or round robin trades, or that uses other financing techniques for its Covered Agency Transactions. See proposed FINRA Rule 4210(e)(2)(H)(ii)c.2. and Rule 4210(e)(2)(H)(ii)e. in Exhibit 5.

whether trades include a special financing technique, such as dollar roll or other financing techniques, or whether the trades are settled DVP or for cash.

B. Economic Impact

The proposed rule change is expected to enhance sound risk management practices for all parties involved in the TBA market. Further, the standardization of margining practice should create a fairer environment for all market participants. Ultimately, the proposed rule change is expected to mitigate counterparty risk to protect both sides to a transaction from a potential default.

As discussed earlier, FINRA has made revisions to the proposed rule change as published in the Notice to ameliorate the proposal's impact on business activity and to address the concerns of smaller customers that do not pose material risk to the market as a whole, in particular those engaging in non-margined, cash only business. After considering comments received in response to the Notice, as well as extensive discussions with industry participants and other regulators, FINRA's proposed revisions include among other things the establishment of an exception from the proposed margin requirements for any counterparty with gross open positions amounting to $2.5 million or less, subject to specified conditions, as well as specified exceptions to the maintenance margin requirement and modifications to the de minimis transfer provisions.

FINRA understands that there will likely be direct and indirect costs of compliance associated with the proposed rule change as revised. Some of the direct costs are largely fixed in nature, and mostly include initial start-up costs, such as acquiring systems, software or technical support, and allocating staff resources to manage a margining regime. Direct costs would also entail developing necessary procedures and establishing monitoring mechanisms. FINRA anticipates that a significant cost of the proposed rule change is the commitment of capital to meet the margin requirements. The magnitude of this cost depends on the trading activity of each party, each party's access to capital, and each party's having the capital reserves necessary to fulfill margin obligations. FINRA's experience with supervision of risk controls at larger firms suggests that at present substantially all such firms have systems in place for managing the margining of Covered Agency Transactions, and thus the system costs of the proposed rule change would result from extending the systems to the margining of transactions covered by the proposed rule change for those firms. In addition, as discussed above, FINRA understands that TMPG members at present require a substantial portion of their counterparties to post mark to market margin, implying that those firms should already have the systems and staff to facilitate margining practices and manage capital allocated. Therefore, FINRA believes that most start-up costs are likely to be incurred by smaller market participants that might have to establish the necessary systems for the first time.

FINRA understands that the margin requirements for TBA market transactions may also impose indirect costs. These costs may result from changed market behavior of some participants. Some parties who currently transact in the TBA market may choose to withdraw from or limit their participation in the TBA market. Reduced participation may lead to decreased liquidity in the market for certain issues or settlement periods, potentially restricting access to end users and increasing costs in the mortgage market. These market-wide impacts on liquidity would be limited if exiting market participants represent a small proportion of market transactions while market participants that choose to remain, or new participants that choose to enter the market, increase their activities and thereby offset the impact of participants that exit the market.

The potential impacts of the proposed rule change on mortgage bankers, broker-dealers, investors and consumers of mortgages are discussed in turn below.

1. Mortgage Bankers

Based on discussions with market participants and other regulators, FINRA understands that mortgage bankers are among the largest group of customers in the TBA market – following institutional buyers – as the forward-settling nature of MBS transactions provides mortgage bankers with the opportunity to lock in interest rates as new loans are originated. These transactions give mortgage lenders an opportunity to hedge their exposures to interest rate risk between the time of origination and the sale of the home loan in the secondary market.

To estimate the potential burden on mortgage bankers, FINRA analyzed the data described above that was provided by a major clearing broker. As discussed earlier, the proposed rule change establishes a $250,000 de minimis transfer amount below which the member need not collect margin, subject to specified conditions,[77] and establishes an exception from the proposed margin requirements for any counterparty with gross open positions amounting to $2.5 million or less, subject to specified conditions.[78] FINRA believes that it may reasonably estimate the trades that would be subject to the $2.5 million per counterparty exception in the sample even though information describing the

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77 See proposed FINRA Rule 4210(e)(2)(H)(ii)f. in Exhibit 5.

78 See proposed FINRA Rule 4210(e)(2)(H)(ii)c.2. in Exhibit 5.

specified contractual settlement terms that are elements of the exception are not available.[79]

For these data, FINRA finds that only nine of the 375 accounts would have an obligation to post margin on a total of 35 days for their open positions as of May 30, 2014 if subject to the proposed rule change. By this analysis, less than 0.01% of the 14,001 account-day combinations in the sample would be required to provide margin on their TBA positions. For those accounts that would be required to post margin on any day during the period studied, FINRA estimates the average (median) net daily margin to be posted on these 35 days to be $595,191 ($384,180) for an average (median) gross exposure of $246,901,235 ($253,111,500).[80] The ratio of the estimated margin to the gross exposure ranges between 0.06% and 4.34% and has a mean (median) of 0.54% (0.29%). The gross positions across all days studied for the remaining 366 accounts result in an estimated mark to market obligation that is less than the de minimis transfer amount, and hence no obligations would be incurred.

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[79] For purposes of this analysis, FINRA assumes that these positions include no financing trades, and thus all aggregate positions with a single counterparty under the $2.5 million threshold would be excepted from the mark to market margining requirements. FINRA considers this assumption as reasonable because FINRA understands from subject matter experts that mortgage bankers do not traditionally employ TBA contracts for financing. Further, this assumption does not materially affect estimates of margin obligation under the rule, since only a few positions would have to post margin due to the $250,000 de minimis transfer amount exception.

[80] For a given customer account at a broker-dealer, margin (assuming the application of mark to market margin) is computed for each net long or short position, by CUSIP, in Covered Agency Transactions by multiplying the net long or short contract amount by the daily price change. The margin for all Covered Agency Transactions is the sum of the margin required on each net long or net short position. On the day following the start of the contract, the price change is measured as the difference between the original contract price and the end of day closing price.

To the extent that the sample considered in this analysis is representative, it appears that mortgage bankers have smaller gross exposures, on average, and more positions that would generate margin obligations that are less than the $250,000 de minimis transfer amount. Accordingly, FINRA expects that the majority of the mortgage bankers' positions would be excepted from the proposed margin requirements.

The Notice invited commenters to provide information concerning the potential costs and burdens that the amendments could impose. As discussed earlier, the proposed rule change would permit members to treat mortgage bankers that use Covered Agency Transactions to hedge their pipeline of mortgage commitments as exempt accounts. Members would be required to adopt procedures to monitor the mortgage banker's pipeline of mortgage loan commitments to assess whether the Covered Agency Transactions are being used for hedging purposes.[81] Some commenters in response to the Notice expressed concern that this would harm the ability of mortgage bankers to compete. Commenters suggested that mortgage bankers should be permitted flexibility to negotiate their margin obligations, that they should be treated as exempt accounts regardless of the extent to which they are hedging, that monitoring hedging by mortgage bankers would be too burdensome, that the costs of compliance would drive mortgage bankers to shift to non-FINRA member counterparties, that margin requirements should be modified to reflect the costs of hedging, and that the $250,000 de minimis transfer threshold would be too restrictive.[82]

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81 See proposed FINRA Rule 4210(e)(2)(H)(ii)d. and Rule 4210.02 in Exhibit 5.

82 Baum, BB&T, BDA, Brean, Duncan-Williams, MBA, MountainView, Shearman and SIFMA.

In response, FINRA understands the importance of the role of mortgage bankers in the mortgage finance market and for that reason designed the proposed rule change to include the provision for members to treat mortgage bankers as exempt accounts with respect to their hedging. However, FINRA believes that it would work against the rule's overall purposes to create a pathway for a mortgage banker that is not otherwise an exempt account to engage in speculation in the TBA market, which could create incentives leading to distortions in trading behavior. In the presence of such incentives, FINRA believes it reasonable to expect a party to more frequently enter into transactions that are primarily speculative in nature. In fact, where other market participants would be constrained by the rule, these types of transactions might be more profitable than they are today. As noted earlier, the proposed rule change accommodates the business of mortgage bankers by providing exempt account treatment to the extent the member has conducted sufficient due diligence to determine that the mortgage banker is hedging its pipeline of mortgage production. Again, as discussed earlier, FINRA notes that the current Interpretations under Rule 4210 already contemplate that members evaluate the loan servicing portfolios of counterparties that are being treated as exempt accounts.[83]

2. Broker-Dealers

FINRA believes that currently broker-dealers are the main providers of liquidity in the TBA market and their trading behavior impacts nearly all market participants. While the direct costs of margin requirements will be similar to those of mortgage bankers, the initial costs are likely much lower in aggregate as many of these firms have systems in place to manage margining practices.

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[83] See note 53 supra.

FINRA understands that, currently, there are 153 members of MBSD that already follow mark to market margining procedures required by MBSD. Of those 153 firms, 38 are FINRA members, including the ten most active broker-dealers in the TBA market, who collectively account for approximately 77% of the dollar trading volume reported in TRACE. FINRA believes that start-up costs will likely be incurred by smaller and regional members that are not MBSD members. Some of these smaller and regional firms may already be in the process of establishing in-house solutions or outsourcing margining management in order to follow the TMPG recommendations.

FINRA computed bilateral interdealer TBA exposures using approximately 1.10 million TBA trades between March 1, 2012 and July 31, 2013 reported to TRACE and estimated the mark to market margin that counterparties would have been required to post if the proposed margin requirements existed during the sample period. The mean (median) interdealer trade size is $33.98 million ($5.31) and the mean difference between the trade date and contractual settlement date is 25.2 days (20 days).[84] Estimated margin obligations below the $250,000 de minimis transfer amount account for approximately 85.68% of all transactions. This result suggests that a great majority of the aggregate gross exposures held by broker-dealers could be excepted from the proposed margin requirements, subject to specified conditions.[85] As expected, broker-dealers with

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84 For dollar roll transactions, the mean trade size is $76.56 million (a median of $21.01 million), whereas, for non-financing transactions, the mean trade size is $20.28 million (a median of $5.18 million).

85 FINRA understands that a significant portion of the interdealer trades go through MBSD.

relatively smaller aggregate exposures in the TBA market have a relatively larger share of their transactions that would be subject to the de minimis transfer exception.[86]

TRACE has a specific flag that identifies certain transactions as dollar rolls, a type of financing trade to which specified exceptions under the proposed rule change are not available. But dollar rolls are not the only type of financing trades specified under the proposed rule. Therefore, the analysis above potentially underestimates the number and dollar value of transactions that would be subject to both maintenance and mark to market margin if held in non-exempt accounts under the proposed rule.

Using the same method employed above,[87] FINRA estimates that approximately half of the broker-dealers transacting in the TBA market would not have to post mark to market margin throughout the sample period due to the de minimis transfer amount exception. Of the remaining broker-dealers, 38% would have to post margin on less than 10% of the days for which they hold non-zero aggregate gross exposures. The remaining 12% would have to post margin on more than 10% of the days for which they hold non-zero aggregate gross exposure, although none of these broker-dealers would have had a mark to market margin requirement for more than 37.5% of the days for which they held non-zero aggregate gross exposures. In the sample of broker-dealers that would incur margin obligation, a broker-dealer would be required to post an average (median) daily margin of $84,748 ($0) for an average (median) gross exposure of $1.29 billion ($68.68

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86 For purposes of the analysis, FINRA sorted broker-dealers in descending order based on their aggregate positions and analyzed them in two subsamples. On average, approximately 99% of the aggregate gross exposures of smaller broker-dealers (the half with smaller aggregate positions) would result in a margin obligation below the $250,000 threshold.

87 See note 80 supra for the margin calculation methodology.

million). When the analysis is limited to the days that margin obligations would be incurred under the rule, the average (median) margin obligation to be posted to a counterparty is estimated to be $1.14 million ($591,952) for an average (median) exposure of $5.71 billion ($2.07 billion) and accounts for approximately 0.02% of the aggregate gross exposure value. Based on the entire sample, FINRA estimates that a broker-dealer would incur an average (median) monthly margin obligation of $24,235,867 ($0) for an average (median) aggregate gross counterparty exposure of approximately $16.47 billion ($239 million). When the analysis is limited to those broker-dealers that would have incurred a margin obligation under the rule in the sample period, the average (median) monthly margin obligation would be approximately $33.76 million ($1.29 million) for an average (median) aggregate gross exposure of $22 billion ($777 million). The sizeable differences between average and median values reported here are due to a few large broker-dealer positions in the sample.

In response to the Notice, some commenters expressed concern that the amendments would place small and mid-sized broker-dealers at a disadvantage. Specifically, commenters suggested that smaller firms have limited resources to meet the anticipated compliance costs, that costs would fall disproportionately on smaller firms that are active in the MBS and CMO markets, that business would shift to non-FINRA members, that the proposal unfairly favors larger or “too big to fail” firms with easier access to resources, that the proposal would result in consolidation of the industry, that the system and infrastructure costs faced by smaller firms would be prohibitive, and that they have never observed a degradation in value of the products between trade date and settlement date.[88] Some commenters suggested such costs as: up to $500 per account for compliance; an outlay of $600,000 to purchase necessary software; payments of up to $100,000 in annual fees; payments of up to $400,000 in outsourcing costs; total costs of up to $1 million per year; or, according to one commenter, system costs as high as $15 million per year.[89]

FINRA is sensitive to the concerns expressed by firms. However, as discussed earlier, FINRA believes that to assert that no degradation has been observed in the TBA market (other than that associated with the collapse of Lehman) does not of itself demonstrate that there is no credit risk in this market. TBA market participants have exposure to significant counterparty credit risk, defined as the potential failure of the counterparty to meet its financial obligations.[90] The lack of margining and proper risk management can lead to a buildup of significant counterparty exposure, which can create correlated defaults in the case of a systemic event. While the implementation of the proposed requirements creates a regulatory cost, incurred by establishing or updating systems for the management of margin accounts, the benefits should accrue over time and help maintain a properly functioning retail mortgage market even in stressed market conditions. FINRA believes that this, in turn, should help create a more stable business environment that should benefit all market participants.

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[88] Ambassador, Baird, BB&T, BDA, Brean, Clarke, Duncan-Williams, FirstSouthwest, Mischler, Pershing, Shearman, SIFMA and Simmons.

[89] Baird, Baum, BDA, Clarke and Sandler.

[90] Counterparty credit risk increases axiomatically during volatile market conditions, as recently experienced in the TBA market in the summer of 2011.

With respect to the specific cost amounts suggested by commenters, FINRA notes that, though compliance with the proposed amendments will involve regulatory costs, as noted above, most of these would be incurred as variable costs as margin obligations or fixed startup costs for purchase or upgrading of software. FINRA believes, based on discussions with providers, that the proffered estimates by commenters are plausible but fall towards the higher end of the cost range for building, upgrading or outsourcing the necessary systems. Further, FINRA believes that, particularly for smaller firms, the proposed $250,000 de minimis amount and $2.5 million per counterparty exception should serve to mitigate these costs.

3. Retail Customers and Consumers

In response to the Notice, some commenters expressed concern that the amendments would result in higher costs to retail customers who participate in the MBS and CMO market. Commenters suggested that recordkeeping costs for investors with exposures to these securities would increase significantly; these increased costs would likely disincline them to participate in the market; and that those who wanted to maintain their exposure would face liquidity constraints in posting margin.[91] On the other hand, one commenter did not agree that impact on retail customers would be significant as they rarely trade in the TBA market on a forward-settlement basis.[92]

In response, FINRA notes that the purpose of the margin rules is to protect the market participants from losses that could stem from increased volatility and the ripple effects of failures. This is a by-product that provides direct protection to the customers of

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91 Ambassador, Baum, BDA and Coastal.

92 BB&T.

members.[93] Margin requirements protect other customers of a member firm from the speculation and losses of other large customers.

Other commenters drew attention to potential negative impacts to the consumer market, suggesting that the amendments would chill the mortgage market and impose liquidity constraints because mortgage bankers would face higher costs that would be passed on to consumers of mortgages.[94] However, FINRA notes that there is mixed evidence regarding the impact of margin requirements on trading volume and market liquidity. For instance, in one of the earlier studies, researchers found that margin requirements negatively affect trading volume in the futures market, a finding consistent with expectations from theory.[95] More recently, other researchers have provided evidence from a foreign derivatives market that margin has no impact on trading volume.[96] Thus, claims that the margin requirement will have a negative impact on market activity, and hence on mortgage rates, are not fully supported by empirical findings in other similar markets.

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93 See discussion of the original objectives of margin regulation in Jules I. Bogen & Herman Edward Krooss, Security Credit: Its Economic Role and Regulation 88–89 (Englewood Cliffs, NJ Prentice-Hall 1960).

94 MBA and MetLife.

95 See Hans R. Dutt & Ira L. Wein, Revisiting the Empirical Estimation of the Effect of Margin Changes on Futures Trading Volume, 23 The Journal of Futures Markets, (Issue 6) 561–76 (2003).

96 See Kate Phylaktis & Antonis Aristidou, Margin Changes and Futures Trading Activity: A New Approach, 19 European Financial Management, (Issue 1) 45–71 (2013).

C. Interest Rate Volatility and Margin Requirements

The historically low and stable interest rates that the United States has experienced over the last several years might lead FINRA to underestimate the margin that market participants would have to post in a more volatile market, and thus underestimate the impact of the rule proposal.

To assess the likely impact of the rule on the margin obligation in a more volatile interest rate environment, FINRA has estimated the volatility[97] in the TBA market across two periods with different interest rate characteristics, relying on Deutsche Bank's TBA index.[98] The first period that FINRA analyzed is from July 1, 2012, to June 30, 2014. The average yield on the 10-year U.S. Treasury note in this period was measured at 2.25%. The second period FINRA analyzed is from June 1, 2004 to May 31, 2006. This second period was marked by a substantially higher average 10-year U.S. Treasury yield, measured at 4.14%. However, FINRA estimates the volatility in the TBA index to have been effectively the same, at 3.95%, in both periods. FINRA believes this analysis suggests that volatility in the TBA market is not expected to significantly increase if interest rates increase in the future.[99] Therefore, a margin obligation for broker-dealers of

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97 For purposes of this section, volatility refers to the standard deviation, statistically computed, of the distribution of a dataset.

98 For further information, see DB US Mortgage TBA Index, available at: <https://index.db.com/servlet/MBSHome>.

99 Alternatively, FINRA compared the first period with another, even more volatile interest rate environment, from June 1, 1999 to May 31, 2000, during which the average yield on the 10-year Treasury note was 6.14%. FINRA estimates that the volatility of the TBA index in that period was 4.30%, suggesting that volatility in the TBA market would not be expected to significantly increase in a more volatile interest rate environment.

approximately 2% of the contract value over the life of a TBA market security appears to be a reasonable estimate.

D. Indirect Costs of the Proposed Margin Requirements

There are several provisions in the proposal that may potentially alter market participants' behavior in order to minimize the anticipated costs associated with the proposed rule. Such changes in behavior could potentially make trading more difficult for some settlement periods or contract sizes.

As proposed in the Notice, the proposed rule change provides a $250,000 de minimis transfer amount below which the member need not collect margin, subject to specified conditions. FINRA notes that this might create an incentive to trade contract sizes smaller than the threshold amount by splitting large contracts into contracts with smaller sizes. This behavior can potentially make larger contracts harder to trade, and hence decrease liquidity in such trades. FINRA does not anticipate that such a reaction would impact the total liquidity in the TBA market. Rather, the impact could manifest itself in increased transaction costs for trading a larger position in smaller lots.

With respect to the $2.5 million per counterparty exception, FINRA notes that the parameters for the settlement periods specified in the proposed rule may create an incentive to time trading (so that the original contractual settlement is in the month of the trade date or in the month succeeding the trade date, as provided in the rule) and thereby alter trading patterns in order to avoid margin obligations. For example, FINRA identified 582,435 trades from TRACE where the difference between the settlement date and the trade date is longer than 30 days but less than 61 days. Assuming that these trades meet all other conditions specified in the rule, approximately 78% of them would qualify for the $2.5 million per counterparty by virtue of settling within the specified timeframes. In the presence of the proposed rule, FINRA anticipates that some traders might alter the timing of their trades, others might incur higher costs to achieve the same economic exposure, and others yet might choose not to enter into trades with those costs.

As discussed further in Item 5 of this filing, some commenters in response to the Notice suggested that market participants, in response to the costs imposed by the rule, might shift their trades to other counterparties that are not required by regulation to collect margin.[100] As discussed above, there are significant efforts among TMPG institutions to impose mark to market margin on these transactions. Based on discussions with market participants, FINRA understands, as discussed earlier, that members of the TMPG have begun imposing mark to market margin requirements on some of their clients in order to adhere to the best practices suggested by the group. However, FINRA understands, based on the TMPG Report, that the daily average customer-to-dealer transaction volume is around $100 billion, of which approximately two-thirds is unmargined.[101] FINRA also understands that there is a small number of financial institutions that currently deal in the TBA market but are not broker-dealers or members of TMPG. FINRA anticipates that there would be limited scope for such institutions to participate in the TBA market on a large scale without facing a counterparty that would require margin. FINRA will recommend to the agencies supervising such dealers that they similarly apply margin requirements.

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[100] Ambassador, Baird, BB&T, BDA, Brean, Clarke, Duncan-Williams, FirstSouthwest, Mischler, Pershing, Shearman, SIFMA and Simmons.

[101] See note 9 supra.

E. Alternatives Considered

FINRA considered a number of alternatives in developing the proposed rule change. As discussed further in Item 5 of this filing, FINRA considered, among other things, alternative formulations with respect to concentration limits, excepting certain product types from the margin requirements, excepting trades with longer settlement cycles from the margin requirements, modifications to the de minimis transfer provisions, modifications to the proposed risk limit determination provisions and establishing exceptions for mortgage brokers from some or all provisions of the proposed rule. For example, FINRA considered establishing an exception from the proposed margin requirements for transactions settling within an extended settlement cycle. However, FINRA has been advised by market participants and other regulators, including the staff of the FRBNY, that such an exception could potentially result in clustering of trades around the specified settlement cycles in an effort to avoid margin expenses. Such a practice would fundamentally undermine FINRA's goal of improving counterparty risk management. Accordingly, as discussed further in Item 5, FINRA determined to retain the specified settlement cycles in the proposed definition of Covered Agency Transactions as set forth in the Notice and, as an alternative, to establish the $2.5 million per counterparty exception.

FINRA also evaluated various options for the proposed maintenance margin requirement. FINRA analyzed maintenance margin requirements imposed by regulators for other forward settling contracts. These regulators have adopted margin requirements that reflect the risk in these products, while balancing the cost of the margin requirements.

Based on this analysis, as discussed above, FINRA has determined to propose 2% as the appropriate maintenance margin rate, as specified in the proposed rule.

5. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

The proposed rule change was published for comment in Regulatory Notice 14-02 (January 2014) (the "Notice"). Twenty-nine comments were received in response to the Notice. A copy of the Notice is attached as Exhibit 2a. A list of commenters[102] is attached as Exhibit 2b. Copies of the comment letters received in response to the Notice are attached as Exhibit 2c. Detailed discussion of the comments received on the proposed rule change, and FINRA's response, follows below. A number of the comments that speak to the economic impact of the proposed rule change are addressed in Item 4 of this filing.

A. Scope of Products

As proposed in the Notice, the rule change would apply to: (1) TBA transactions,[103] inclusive of ARM transactions, for which the difference between the trade date and contractual settlement date is greater than one business day; (2) Specified Pool Transactions[104] for which the difference between the trade date and contractual settlement date is greater than one business day; and (3) transactions in CMOs,[105] issued in conformity with a program of an Agency or GSE, for which the difference between the

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102 All references to commenters are to the commenters as listed in Exhibit 2b.

103 See note 2 supra.

104 See note 3 supra.

105 See note 4 supra.

trade date and contractual settlement date is greater than three business days.[106] As discussed in the Notice and in Item 3 of this filing, these product types and settlement cycles are congruent with the recommendations of the TMPG.

Commenters expressed concern that the scope of products proposed to be covered by the rule change is overbroad, that the TBA market has not historically posed significant risk and that regulation in this area is not necessary.[107] Commenters suggested that imposing margin requirements on these types of products would have detrimental effects on various market participants, in particular smaller member firms, mortgage bankers, investors and consumers of mortgages, and that these detrimental effects would outweigh the regulatory benefit.[108] Many commenters suggested FINRA should ameliorate the proposal's impact by excluding some of the product types altogether, or by specifying a longer excepted settlement cycle than the proposed one business day with respect to TBA transactions and Specified Pool Transactions and three business days with respect to CMOs.[109] For example, some commenters suggested that by imposing requirements solely on TBA transactions, and eliminating Specified Pool Transactions,

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106 As proposed in the Notice, the products covered by the proposed rule change are defined collectively as "Covered Agency Securities." FINRA has revised this term to read "Covered Agency Transactions," which FINRA believes is clearer and more consistent with the proposal's intent to reach forward settling transactions, as discussed further below.

107 Ambassador, BDA, Coastal, Duncan-Williams, FirstSouthwest, MetLife, Mischler, PIMCO and Vining Sparks.

108 See Items 4.B.1 through 4.B.3 of this filing for discussion of the proposal's economic impact on mortgage bankers, broker-dealers and retail customers and consumers.

109 Ambassador, Baird, Baum, BB&T, BDA, Coastal, Crescent, FirstSouthwest, MBA, MetLife, Pershing, PIMCO and SIFMA.

ARMs or CMOs from the proposal, FINRA would be able to address most of the risk that exists in the TBA market overall while at the same time avoid causing undue disruption.[110] Some commenters also recommended that, if FINRA determines to impose margin on the TBA market, then FINRA should specify, for all products covered by the proposal, three or five-day settlement cycles. Commenters suggested that margining for settlement cycles of less than three days would be too burdensome for smaller firms in particular, is unnecessary as it leads to margining of cash settled transactions, and does not truly address forward settling transactions.[111]

As discussed earlier, in response to commenter concerns, FINRA has engaged in extensive discussions with market participants and other supervisors, including staff of the FRBNY. To ameliorate potential burdens on members, FINRA considered, among other things, various options for narrowing the covered product types. The FRBNY staff has advised FINRA that, such modifications to the proposal would result in a mismatch between FINRA standards and the TMPG best practices, thereby resulting in perverse incentives in favor of non-margined products and leading to distortions of trading behavior.

FINRA is proposing, as an alternative approach in response to commenter concerns, to establish an exception from the proposed margin requirements that would apply to any counterparty that has gross open positions[112] in Covered Agency

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[110] Ambassador, Baum, BDA, Coastal, FirstSouthwest and SIFMA.

[111] Baird, BB&T, BDA, FirstSouthwest, ICI, MetLife, PIMCO and SIFMA.

[112] The proposal defines "gross open positions" to mean, with respect to Covered Agency Transactions, the amount of the absolute dollar value of all contracts entered into by a counterparty, in all CUSIPs. The amount must be computed net of any settled position of the counterparty held at the member and deliverable

Transactions amounting to $2.5 million or less in aggregate, if (1) the original contractual settlement for all the counterparty's Covered Agency Transactions is in the month of the trade date for such transactions or in the month succeeding the trade date for such transactions and (2) the counterparty regularly settles its Covered Agency Transactions on a DVP basis or for cash.[113] This exception would not apply to a counterparty that, in its transactions with the member, engages in dollar rolls, as defined in FINRA Rule 6710(z),[114] or round robin trades,[115] or that uses other financing techniques for its Covered Agency Transactions.[116]

Though FINRA shares commenters' concerns regarding the potential effects of margin in the TBA market, FINRA believes that margin is needed because the 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 posing risk to the member extending credit and to the marketplace and potentially imposing, in economic terms, negative externalities on the financial system in the event of failure. While the volatility

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under one or more of the counterparty's contracts with the member and which the counterparty intends to deliver.

113 See proposed FINRA Rule 4210(e)(2)(H)(ii)c.2. in Exhibit 5.

114 See note 47 supra.

115 The term "round robin" trade is defined in proposed FINRA Rule 4210(e)(2)(H)(i)i. to mean any transaction or transactions resulting in equal and offsetting positions by one customer with two separate dealers for the purpose of eliminating a turnaround delivery obligation by the customer.

116 FINRA believes that the exception would not be appropriate for dollar rolls, round robin trades or trades involving other financing techniques for the specified positions given that these transactions generate the types of exposure that the rule is meant to address.

in the TBA market seems to respond only slightly to the volatility in the U.S. interest rate environment (proxied by the 10-year U.S. Treasury yield),[117] FINRA notes that price movements in the TBA market over the past five years suggest that the market still has potential for a significant amount of volatility.[118] Accordingly, FINRA believes it would undermine the effectiveness of the proposal to modify the product types to which the proposal would apply or to modify the applicable settlement cycles. However, FINRA does not intend the proposal to unnecessarily burden the normal business activity of market participants, or to otherwise alter market participants' trading decisions. To that end, FINRA believes it is appropriate to establish the specified $2.5 million per counterparty exception. Based on discussions with market participants and analysis of selected data,[119] FINRA believes that this should significantly reduce potential burdens on members by removing from the proposal's scope smaller intermediaries that do not pose systemic risk.[120] Further, as discussed earlier, because many such intermediaries

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[117] See Item 4.C of this filing.

[118] To assess volatility in the TBA market, FINRA looked to several sources of information, including: (i) five-day price changes over the previous five years based on selected Deutsche Bank indices designed to track the TBA market (five days corresponds with the proposed settlement cycle and is consistent with the payment period under Regulation T); (ii) margin requirements for interest rate contracts traded on the Chicago Board of Trade ("CBOT") and cleared at Chicago Mercantile Exchange ("CME"); and (iii) margin requirements for repurchase contracts.

[119] Based on analyses of TRACE data, FINRA found that about 30 percent of customer trades over selected periods were in amounts under $2.5 million. These trades amounted to approximately half of one percent of the total dollar volume of activity in the TBA market over the selected periods. See also discussion in Item 4 of this filing.

[120] FINRA believes that transactions falling within the proposed $2.5 million per counterparty exception do not pose systemic risk given that, as noted above, such transactions are a small portion of the total dollar volume of activity in the TBA

deal with smaller counterparties, this will reduce the burdens that would be associated with applying the new margin requirements for Covered Agency Transactions.

B. Maintenance Margin

As proposed in the Notice, for transactions with non-exempt accounts, members would be required to collect mark to market margin and to collect maintenance margin equal to 2% of the market value of the securities.

Commenters expressed concerns about the proposed maintenance margin requirement. Some suggested that imposing a maintenance margin requirement would place FINRA members at a competitive disadvantage because investors, rather than bear these types of disproportionate costs, would prefer to leave the TBA market entirely or would take their business to banks or other entities not subject to the requirement.[121] Commenters suggested that a maintenance margin requirement is unnecessary because the aggregate size of the TBA market makes the products easier to liquidate and defaulted positions easier to replace, that there is no precedent for maintenance margin in the TBA market, and that the proposed requirement is not within the scope of the TMPG's recommendations.[122] Some commenters suggested that maintenance margin would not provide significant protection and that the proposal should establish various tiered approaches, such as thresholds based on transaction amounts or permitting the members

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market. However, similar to de minimis transfer amounts as discussed further below, FINRA has revised the proposed rule change to clarify that amounts subject to the exception would count toward a member's concentration limits as set forth under paragraph (e)(2)(I) of the rule as redesignated. See Item 5.F of this filing.

121 AIA, Clarke, Credit Suisse, Shearman, SIFMA and SIFMA AMG.

122 AMG, BDA, Clarke, FIF, FirstSouthwest, Sandler and SIFMA.

to negotiate the margin based on their risk assessments.[123] On the other hand, some commenters suggested they support or at least do not object to maintenance margin at specified percentages of market value or for some of the products.[124]

In response to commenter concerns, FINRA is revising the proposed maintenance margin requirement for non-exempt accounts. Specifically, the member would be required to collect maintenance margin equal to two percent of the contract[125] value of the net long or net short position, by CUSIP, with the counterparty.[126] However, no maintenance margin would be required if the original contractual settlement for the Covered Agency Transaction is in the month of the trade date for such transaction or in the month succeeding the trade date for such transaction and the customer regularly settles its Covered Agency Transactions on a DVP basis or for cash. Similar to the proposed $2.5 million per counterparty exception, the exception from the required maintenance margin would not apply to a non-exempt account that, in its transactions with the member, engages in dollar rolls, as defined in FINRA Rule 6710(z), or round robin trades, or that uses other financing techniques for its Covered Agency Transactions.

The TMPG recommendations do not include maintenance margin. FINRA understands, however, that the TMPG does not oppose the proposed maintenance margin

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123 Baird, BB&T, Clarke, Duncan-Williams, Shearman and Vining Sparks.

124 MountainView and Pershing.

125 As proposed in the Notice, the rule would specify "market value." FINRA has replaced "market value" with "contract value" as more in keeping with industry usage.

126 See the definition of "maintenance margin" under proposed FINRA Rule 4210(e)(2)(H)(i)f. and the treatment of non-exempt accounts pursuant to proposed FINRA Rule 4210(e)(2)(H)(ii)e. in Exhibit 5.

requirements. Commenters opposed maintenance margin because of its impact on non-exempt accounts.[127] However, FINRA believes the proposed two percent amount aligns with the potential risk in this area. FINRA's analysis of selected indices designed to track the TBA market over the past five years identified instances of price differentials of approximately two percent over a five-day period.[128] Further, FINRA notes that two percent aligns with the standard haircut for reverse repo transactions in FNMA, GNMA and FHLMC mortgage pass-through certificates[129] and approximates the amount charged by MBSD. The two percent amount also approximates the initial margin charged by the CME Group for corresponding products.[130] Accordingly, the two percent amount that FINRA proposes is consistent with other risk measures in this area. FINRA believes that transactions that are similar in economic purpose should receive the same economic treatment in the absence of a sound reason for a difference.

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127 FINRA notes that the assertion that maintenance margin in this market is unprecedented is incorrect. Under current Interpretation /05 of Rule 4210(e)(2)(F), maintenance margin of five percent is required for non-exempt counterparties on transactions with delivery dates or contract maturity dates of more than 120 days from trade date.

128 Indeed, the distribution of five-day price differentials is not a "normal" Gaussian Bell curve, but has a "fat tail" especially on the price decline side.

129 FINRA notes reverse repos are a valid point of comparison because a TBA transaction is very similar in effect to a dealer firm repoing out securities to a counterparty for a term that ends at the date a TBA would settle in the future.

130 FINRA's information as to margin requirements for TBA transactions cleared by MBSD and for repurchase transactions for FNMA, GNMA and FHLMC mortgage pass-through certificates is based on discussions the staff has had with market participants. Margin requirements on various interest rate futures contracts cleared by CME Group is available at: <www.cmegroup.com/trading/interest-rates/us-treasury/ultra-t-bond_performance_bonds.html> (for Ultra U.S. Treasury Bond contracts) and <http://www. cmegroup.com/trading/interest-rates/us-treasury/30-year-us-treasury-bond_performance_bonds.html> (for U.S. Treasury Bond contracts).

By the same token, in order to tailor the requirement more specifically to the potential risk, and to address commenters' concerns, FINRA believes that it is appropriate to create the exception for transactions where the original contractual settlement is in the month of the trade date for the transaction or in the month succeeding the trade date for the transaction and the customer regularly settles its Covered Agency Transactions DVP or for cash. FINRA believes that transactions that settle DVP or for cash in this timeframe pose less risk, thereby lessening the need for maintenance margin and reducing potential burdens on members. As discussed earlier, FINRA believes that the exception would not be appropriate for counterparties that, in their transactions with the member, engage in dollar rolls, round robin trades or trades involving other financing techniques for the specified positions given that these transactions generate the types of exposure that the rule is meant to address.

C. De Minimis Transfer

As proposed in the Notice, the proposed rule change would provide for a minimum transfer amount of $250,000 (the "de minimis transfer") 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.

Commenters voiced various concerns about the proposed de minimis transfer provisions. Some commenters said that members should be permitted to set their own thresholds or to negotiate the de minimis transfer amounts with the counterparties with which they deal.[131] Some commenters proposed alternative amounts or suggested tiering

[131] AII, Baird, BDA, FIF, Shearman and SIFMA.

the amount.[132] Some commenters argued that the de minimis transfer provisions would operate as a forced capital charge on uncollected deficiencies or mark to market losses below the threshold amount, which would unfairly burden smaller firms in particular when aggregated across accounts.[133] Commenters suggested that capital charges should not be required below the threshold amount, or that the de minimis transfer provisions should be eliminated altogether.[134]

In response, FINRA has revised the de minimis transfer provisions to provide that any deficiency or mark to market loss, as set forth under the proposed rule change, with a single counterparty <u>shall not give rise to any margin requirement, and as such need not be collected or charged to net capital</u>, if the aggregate of such amounts with such counterparty does not exceed $250,000.[135] As explained in the <u>Notice</u>, the de minimis transfer provisions are intended to reduce the potential operational burdens on members. FINRA believes it is not essential to the effectiveness of the proposal to charge the uncollected de minimis transfer amounts to net capital, which should help provide members flexibility. FINRA believes that, by permitting members to avoid a capital charge that would otherwise be required absent the de minimis transfer provisions, the proposal should help to avoid disproportionate burdens on smaller members, which is consistent with the proposal's intention. However, FINRA believes it is necessary to set a parameter for limiting excessive risk and as such is retaining the proposed $250,000

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[132] Clarke, Crescent, ICI and MountainView.

[133] Clarke, Sandler and SIFMA.

[134] BDA and Sandler.

[135] <u>See</u> proposed FINRA Rule 4210(e)(2)(H)(ii)f.

amount.[136]

D. Risk Limit Determinations

As proposed in the Notice, members that engage in Covered Agency Transactions with any counterparty would be required to make a written determination of a risk limit to be applied to each such counterparty. The risk limit determination would need to be made by a credit risk officer or credit risk committee in accordance with the member's written risk policies and procedures. As proposed in the Notice, the rule change would further establish a new Supplementary Material .05 to Rule 4210, which would provide that members of limited size and resources would be permitted to designate an appropriately registered principal to make the risk limit determinations.

Some commenters said that the proposed provisions regarding risk limit determinations would be burdensome, that members should be permitted flexibility, that the proposal should allow risk limits to be determined across all product lines (and not be limited to Covered Agency Transactions), and that members should be permitted to define risk limits at the investment adviser or manager level rather than the sub-account level.[137] One commenter said that risk limit determinations should be the responsibility of the broker that introduces the account to a carrying firm.[138]

In response, FINRA has revised proposed Supplementary Material .05 to provide

136 In this regard, FINRA notes that it has revised the proposal's provisions with respect to concentrated exposures to clarify that the de minimis transfer amount, though it would not give rise to any margin requirement, the amount must be included toward the concentration thresholds as set forth under paragraph (e)(2)(I) as redesignated. FINRA believes that this clarification is necessary as a risk control. See Item 5.F of this filing.

137 BB&T, FIF, Duncan-Williams and SIFMA.

138 Pershing.

that, if a member engages in transactions with advisory clients of a registered investment adviser, the member may elect to make the risk limit determinations at the investment adviser level, except with respect to any account or group of commonly controlled accounts whose assets managed by that investment adviser constitute more than 10 percent of the investment adviser's regulatory assets under management as reported on the investment adviser's most recent Form ADV. The member may base the risk limit determination on consideration of all products involved in the member's business with the counterparty, provided the member makes a daily record of the counterparty's risk limit usage.[139] Further, FINRA is revising the Supplementary Material to apply not only to Covered Agency Transactions, as addressed under paragraph (e)(2)(H) of Rule 4210, but also to paragraph (e)(2)(F) (transactions with exempt accounts involving certain "good faith" securities") and paragraph (e)(2)(G) (transactions with exempt accounts involving highly rated foreign sovereign debt securities and investment grade debt securities). These revisions should provide members flexibility to make the required risk limit determinations without imposing burdens at the sub-account level and without limiting the risk limit determinations to Covered Agency Transactions.[140] FINRA

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139 In addition, as revised, the proposed rule change clarifies that the risk limit determination must be made by a designated credit risk officer or credit risk committee. See proposed FINRA Rule 4210(e)(2)(H)(ii)b. and Rule 4210.05 in Exhibit 5.

140 To clarify the rule's structure, FINRA is revising paragraphs (e)(2)(F) and (e)(2)(G) so that the risk analysis language that appears under current, pre-revision paragraph (e)(2)(H), and which currently by its terms applies to both paragraphs (e)(2)(F) and (e)(2)(G), would be placed in each of those paragraphs and deleted from its current location. Accordingly, FINRA proposes to move to paragraphs (e)(2)(F) and (e)(2)(G): "Members shall maintain a written risk analysis methodology for assessing the amount of credit extended to exempt accounts pursuant to [this paragraph], which shall be made available to FINRA upon request." FINRA proposes to further add to each: "The risk limit

believes the 10 percent threshold is appropriate given that accounts above that threshold pose a higher magnitude of risk.

Separately, not in response to comment, as noted earlier[141] FINRA has revised the opening sentence of proposed Rule 4210(e)(2)(H)(ii)b. to provide that a member that engages in Covered Agency Transactions with any counterparty shall make a determination in writing of a risk limit for each such counterparty that the member shall enforce. FINRA believes that this is appropriate to clarify that the member must make, and enforce, a written risk limit determination for each counterparty with which the member engages in Covered Agency Transactions. Further, FINRA is adding to Supplementary Material .05 a provision that, for purposes of any risk limit determination pursuant to paragraphs (e)(2)(F) through (H), a member must consider whether the margin required pursuant to the rule is adequate with respect to a particular counterparty account or all its counterparty accounts and, where appropriate, increase such requirements. FINRA believes that this requirement is consistent with the purpose of a risk limit determination to ensure that the member is properly monitoring its risk and that it is logical for a member to increase the required margin where it appears the risk is greater.

E. Determination of Exempt Accounts

As proposed in the Notice, the rule change provides that the determination of whether an account qualifies as an exempt account must be based on the beneficial

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determination shall be made by a designated credit risk officer or credit risk committee in accordance with the member's written policies and procedures." FINRA believes this is logical as it makes the risk limit language more congruent with the language proposed for paragraph (e)(2)(H) of the rule.

141 See note 39 supra.

ownership of the account. The rule change provides that sub-accounts managed by an investment adviser, where the beneficial owner is other than the investment adviser, must be margined individually.

Commenters expressed concern that exempt account determination and margining at the sub-account level would be onerous, especially for managers advising large numbers of clients.[142] In response, FINRA, as discussed above, is revising the proposed rule change so that risk limit determinations may be made at the investment adviser level, subject to specified conditions. FINRA believes that the proposed risk limit determination language, in combination with the proposed $2.5 million per counterparty exception as discussed above, should reduce potential burdens on members. Individual margining of sub-accounts, however, would still be required given that individual margining is required in numerous other settings and is fundamental to sound practice. FINRA notes that, among other things, an investment adviser cannot use one advised client's money and securities to meet the margin obligations of another without that other client's consent and that current FINRA Rule 4210(f)(4) sets forth the conditions under which one account's money and securities may be used to margin another's debit.

F. Concentration Limits

Under current (pre-revision) paragraph (e)(2)(H) of Rule 4210, a member must provide written notification to FINRA and is prohibited from entering into any new transactions that could increase credit exposure if net capital deductions, over a five day business period, exceed: (1) for a single account or group of commonly controlled accounts, five percent of the member's tentative net capital; or (2) for all accounts

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142 Baird, BB&T, BDA, Clarke, FIF, Mischler, Sandler, Shearman and SIFMA AMG.

combined, 25 percent of the member's tentative net capital. As proposed in the Notice, the proposed rule change would expressly include Covered Agency Transactions, within the calculus of the five percent and 25 percent thresholds.

Several commenters said that the five percent and 25 percent thresholds are too restrictive, that they would be easily reached in volatile markets, that they would have the effect of reducing market access by smaller firms, and that the limits should be raised.[143]

In response, FINRA notes that the five percent and 25 percent thresholds are not new requirements. The thresholds are currently in use and are designed to address aggregate risk in this area. FINRA believes that the suggestion that the thresholds are easily reached in volatile markets, if anything, confirms that they serve an important purpose in monitoring risk. Accordingly, FINRA proposes to retain the thresholds, with non-substantive edits to further clarify that the provisions are meant to include Covered Agency Transactions. In addition, the proposed rule change would clarify that de minimis transfer amounts must be included toward the concentration thresholds, as well as all amounts pursuant to the $2.5 million per counterparty exception as discussed earlier.[144]

G. Central Banks

As proposed in the Notice, the proposed rule change would not apply to Covered Agency Transactions with central banks. As explained in the Notice, 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

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143 BB&T, BDA, FirstSouthwest, Mischler, Sandler, SIFMA and SIFMA AMG.

144 See proposed FINRA Rule 4210(e)(2)(I) in Exhibit 5.

International Settlements. One commenter proffered language to expand the proposed exemption for central banks to include sovereign wealth funds.[145] The Federal Home Loan Banks (FHLB) requested exemption from the requirements on grounds of the low counterparty risk that they believe they present.[146] Two commenters suggested that in the interest of clarity the interpretive language in the Notice as to "central banks" should be integrated into the rule text.[147]

In response, as noted earlier[148] FINRA has revised the proposed rule language as to central banks and similar entities to make the rule's scope more clear and to provide members flexibility to manage their risk vis-à-vis such entities. Specifically, proposed Rule 4210(e)(2)(H)(ii)a.1. provides that, with respect to Covered Agency Transactions with any counterparty that is a Federal banking agency, as defined in 12 U.S.C. 1813(z),[149] central bank, multinational central bank, foreign sovereign, multilateral development bank, or the Bank for International Settlements, a member may elect not to apply the margin requirements specified in paragraph (e)(2)(H) of the rule provided the member makes a written risk limit determination for each such counterparty that the member shall enforce pursuant to paragraph (e)(2)(H)(ii)b. FINRA believes that, in addition to providing members flexibility from the standpoint of managing their risk, the proposal as revised is more clear as to the types of entities that are included within the

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145 SIFMA.

146 FHLB.

147 SIFMA and SIFMA AMG.

148 See note 38 supra.

149 See note 37 supra.

scope of the election that paragraph (e)(2)(H)(ii)a.1. makes available to members. Specifically, the terms Federal banking agency, central bank, multinational central bank, and foreign sovereign are consistent with usage in the "Volcker Rules" as adopted in January, 2014.[150] As explained in the Notice, the inclusion of multilateral development banks and the Bank for International Settlements is consistent with usage by the Basel Committee on Banking Supervision ("BCBS") and the Board of the International Organization of Securities Commissioners ("IOSCO").[151] FINRA does not propose to include sovereign wealth funds, as such entities engage in market activity as commercial participants. Informed by discussions with the FRBNY staff, FINRA does not propose to include other specific entities, other than the Bank for International Settlements on account of its role vis-à-vis central banks, given that FINRA has been advised that doing so would create perverse incentives for regulatory arbitrage. Further, absent a showing that an entity is expressly backed by the full faith and credit of a sovereign power or powers and is expressly limited by its organizing charter as to any speculative activity in which it may engage, including such an entity within the scope of the election made available under paragraph (e)(2)(H)(ii)a.1. would cut against the overall purpose of the rule amendments.

H. Timing of Margin Collection and Transaction Liquidation

The proposed rule change, with minor revision vis-à-vis the version as set forth in

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150 See OCC, Federal Reserve, FDIC and SEC, 79 FR 5536 (January 31, 2014) (Final Rule: Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds).

151 See BCBS and IOSCO, Margin Requirements for Non-Centrally Cleared Derivatives, September 2013, available at: <http://www.bis.org/publ/bcbs261.pdf>.

the Notice, provides that, unless FINRA has specifically granted the member additional time, the member would be required to liquidate positions if, with respect to exempt accounts, a mark to market loss is not satisfied within five business days, or, with respect to non-exempt accounts, a deficiency is not satisfied within such period.

Commenters suggested that the proposed five-day timeframe is too short, that the appropriate timeframe is 15 days, as set forth in current Rule 4210(f)(6), that firms may not be able to collect the margin within the specified timeframe, and that firms should be permitted to negotiate the timeframe with their customers.[152] One commenter sought clarification as to whether a member would be required to take a capital charge on deficiencies on the day such deficiencies are cured.[153]

In response, FINRA believes that the five-day period as proposed is appropriate in view of the potential counterparty risk in the TBA market.[154] Accordingly, the proposed requirement is largely as set forth in the Notice, with minor revision as noted earlier to better align the language with corresponding provisions under FINRA Rule 4210(g)(10)(A) in the context of portfolio margining.[155] Further, consistent with longstanding practice under current Rule 4210(f)(6), FINRA notes that the proposed rule makes allowance for FINRA to specifically grant the member additional time.[156] FINRA

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152 AII, BB&T, BDA, Credit Suisse, Duncan-Williams, ICI, MetLife, Pershing, Sandler, Shearman, SIFMA and SIFMA AMG.

153 SIFMA.

154 In the interest of clarity, FINRA is revising paragraph (f)(6) of Rule 4210 so as to except paragraph (e)(2)(H) of the rule from the 15-day timeframe set forth in paragraph (f)(6).

155 See notes 51, 52 and 55 supra.

156 See proposed FINRA Rule 4210(e)(2)(H)(ii)d.

maintains, and regularly updates, the online Regulatory Extension System for this purpose. With respect to the curing of deficiencies, FINRA notes that the margin rules have consistently been interpreted so that a capital charge, once created, is removed when the deficiency is cured.

I. Miscellaneous Issues

1. Cleared TBA Market Products

One commenter suggested that the proposed amendments should apply to Covered Agency Transactions cleared through a registered clearing agency.[157] FINRA does not propose to apply the requirements to cleared transactions at this time given that such requirements would appear to duplicate the efforts of the registered clearing agencies and increase burdens on members.

2. Introducing and Carrying/Clearing Firms

One commenter sought clarification as to whether introducing firms or carrying/clearing firms would be responsible for calculating, collecting and holding custody of the customer's margin under the proposed amendments.[158] In response, FINRA notes that Rule 4311 permits firms to allocate responsibilities under carrying agreements so that, for instance, an introducing firm could calculate margin and make margin calls, provided, however, that the carrying firm is responsible for the safeguarding of funds and securities for the purposes of SEA Rule 15c3-3.[159]

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157 Brevan.

158 Sandler.

159 With respect to any customer funds and securities, an introducing firm is subject to the obligation of prompt transmission or delivery.

3. Margining of Fails

Three commenters sought clarification as to whether members would be required to margin fails to deliver.[160] In response, FINRA notes that currently Rule 4210 does not require the margining of fails to deliver. However, FINRA notes that members need to consider the relevant capital requirements under SEA Rule 15c3-1, in particular the treatment of unsecured receivables under Rule 15c3-1(c)(2)(iv). FINRA does not propose to address fails to deliver as part of the proposed rule change.

4. Eligible Collateral

Several commenters suggested that FINRA should clarify that the proposal is not specifying what type of collateral a firm should accept and that there should be flexibility for parties to negotiate collateral via the terms of the Master Securities Forward Transaction Agreement (MSFTA).[161] Some commenters suggested the proposal should impose limits with respect to types of collateral.[162] In response, FINRA believes that all margin eligible securities, with the appropriate margin requirement, should be permissible as collateral under Rule 4210 to satisfy required margin.

5. Protection of Customer Margin; Two-Way Margining

One commenter suggested that, in light of the Bankruptcy Court decision concerning TBA products in the Lehman case,[163] FINRA should enhance protection of

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[160] Pershing, Sandler and SIFMA.

[161] AII, Clarke, FIF and SIFMA.

[162] BB&T and Duncan-Williams.

[163] See Memorandum Decision Confirming the Trustee's Determination of Claims Relating to TBA Contracts, In re Lehman Brothers, Inc., Debtor, 462 B.R. 53, 2011 Bankr. LEXIS 4753 (S.D.N.Y. December 8, 2011).

the margin that customers post by requiring that members hold the margin through tri-party custodial arrangements.[164] One commenter suggested that, as a way to manage the risk of Covered Agency Transactions, FINRA should implement two-way margining that would require members to post the same mark to market margin that would be required of counterparties, and that FINRA should, as part of the rule change, permit the use of tri-party custodial arrangements.[165]

In response, though FINRA is supportive of enhanced customer protection wherever possible, implementation of such requirements at this time could impose substantial additional burdens on members, or otherwise raise issues that are beyond the scope of the proposed rule change. FINRA is considering the issue of tri-party arrangements but does not propose to address it as part of the proposed rule change. Further, FINRA supports the use of two-way margining as a means of managing risk but does not propose to address such a requirement as part of the rule change.

6. Unrealized Profits; Standbys

The proposed rule change, with minor revision vis-à-vis the version as set forth in the Notice, provides that unrealized profits in one Covered Agency Transaction may offset losses from other Covered Agency Transaction positions in the same counterparty's account and the amount of net unrealized profits may be used to reduce margin requirements. Further, the rule provides that, with respect to standbys, only profits (in-the-money amounts), if any, on long standbys shall be recognized.

One commenter sought clarification as to whether for long standbys only profits,

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[164] Brevan.

[165] ICI.

not losses, may be factored into the setoff.[166] In response, FINRA notes that this is correct.

7. Definition of Exempt Account

One commenter suggested FINRA should revise the definition of “exempt” account under Rule 4210 to include the non-US equivalents of the types of entities set forth under the definition.[167] In response, FINRA notes that the definition of exempt account plays an important role under Rule 4210 and believes that issue is better addressed as part of a future, separate rulemaking effort.

8. Standardized Pricing

One commenter suggested FINRA should suggest standardized sources for pricing and a calculation methodology for the TBA market.[168] In response, though FINRA agrees that market transparency is important, FINRA does not propose at this time to suggest or mandate sources for valuation, as this currently is a market function. FINRA notes that the FINRA website makes available extensive TRACE data and other market data for use by the public.[169]

9. MSFTA

One commenter sought clarification as to whether FINRA would require a member to have an executed MSFTA in place prior to engaging in any Covered Agency

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166 SIFMA.

167 Shearman.

168 BB&T.

169 See for instance bond data available on the FINRA website at: <http://finra-markets.morningstar.com/BondCenter/Default.jsp>.

Transactions.[170] In response, FINRA does not propose to mandate the use of MSFTAs. FINRA notes, however, that members are obligated under, among other things, the books and records rules to maintain and preserve proper records as to their trading.

10. Implementation

Commenters suggested implementation periods ranging from six to 24 months for the proposed rule change once adopted.[171] In response, FINRA supports in general the suggestion of an implementation period that permits members adequate time to prepare for the rule change and welcomes further comment on this issue.[172]

6. Extension of Time Period for Commission Action

FINRA does not consent at this time to an extension of the time period for Commission action specified in Section 19(b)(2) of the Act.[173]

7. Basis for Summary Effectiveness Pursuant to Section 19(b)(3) or for Accelerated Effectiveness Pursuant to Section 19(b)(2) or Section 19(b)(7)(D)

Not applicable.

8. Proposed Rule Change Based on Rules of Another Self-Regulatory Organization or of the Commission

Not applicable.

9. Security-Based Swap Submissions Filed Pursuant to Section 3C of the Act

Not applicable.

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[170] Vining Sparks.

[171] AII, BB&T, Credit Suisse, FIF, ICI and Pershing.

[172] FINRA understands that firms that are following the TMPG recommendations have been doing so since the recommendations took effect in December 2013.

[173] 15 U.S.C. 78s(b)(2).

10. Advance Notices Filed Pursuant to Section 806(e) of the Payment, Clearing and Settlement Supervision Act

Not applicable.

11. Exhibits

Exhibit 1. Completed notice of proposed rule change for publication in the Federal Register.

Exhibit 2a. FINRA Regulatory Notice 14-02 (January 2014).

Exhibit 2b. List of comment letters in response to FINRA Regulatory Notice 14-02.

Exhibit 2c. Comment letters received in response to FINRA Regulatory Notice 14-02.

Exhibit 5. Text of proposed rule change.

EXHIBIT 1

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34- ; File No. SR-FINRA-2015-036)

Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of a Proposed Rule Change to Amend FINRA Rule 4210 (Margin Requirements) to Establish Margin Requirements for the TBA Market

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)[1] and Rule 19b-4 thereunder,[2] notice is hereby given that on , Financial Industry Regulatory Authority, Inc. (“FINRA”) filed with the Securities and Exchange Commission (“SEC” or “Commission”) the proposed rule change as described in Items I, II, and III below, which Items have been prepared by FINRA. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. <u>Self-Regulatory Organization’s Statement of the Terms of Substance of the Proposed Rule Change</u>

FINRA is proposing to amend FINRA Rule 4210 (Margin Requirements) to establish margin requirements for (1) To Be Announced (“TBA”) transactions, inclusive of adjustable rate mortgage (“ARM”) transactions, (2) Specified Pool Transactions, and (3) transactions in Collateralized Mortgage Obligations (“CMOs”), issued in conformity with a program of an agency or Government-Sponsored Enterprise (“GSE”), with forward settlement dates, as further defined herein (collectively, “Covered Agency Transactions,” also referred to, for purposes of this filing, as the “TBA market”). The proposed rule change redesignates current paragraph (e)(2)(H) of FINRA Rule 4210 as

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1 15 U.S.C. 78s(b)(1).

2 17 CFR 240.19b-4.

new paragraph (e)(2)(I), adds new paragraph (e)(2)(H), makes conforming revisions to paragraphs (a)(13)(B)(i), (e)(2)(F), (e)(2)(G), (e)(2)(I), as redesignated by the rule change, and (f)(6), and adds to the rule new Supplementary Materials .02 through .05.

The text of the proposed rule change is available on FINRA's website at http://www.finra.org, at the principal office of FINRA and at the Commission's Public Reference Room.

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, FINRA included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. FINRA has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

FINRA is proposing amendments to FINRA Rule 4210 (Margin Requirements) to establish requirements for (1) TBA transactions,[3] inclusive of ARM transactions, (2)

[3] FINRA Rule 6710(u) defines "TBA" to mean a transaction in an Agency Pass-Through Mortgage-Backed Security ("MBS") or a Small Business Administration ("SBA")-Backed Asset-Backed Security ("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. Agency Pass-Through MBS and SBA-Backed ABS are defined under FINRA Rule 6710(v) and FINRA Rule 6710(bb), respectively. The term "Time of Execution" is defined under FINRA Rule 6710(d).

Specified Pool Transactions,[4] and (3) transactions in CMOs,[5] issued in conformity with a program of an agency[6] or GSE,[7] with forward settlement dates, as further defined herein[8] (collectively, "Covered Agency Transactions," also referred to, for purposes of this filing, as the "TBA market").

Most trading of agency and GSE MBS takes place in the TBA market, which is characterized by transactions with forward settlements as long as several months past the

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

5 FINRA Rule 6710(dd) defines CMO to mean a type of Securitized Product backed by Agency Pass-Through MBS, mortgage loans, certificates backed by project loans or construction loans, other types of MBS or assets derivative of MBS, structured in multiple classes or tranches with each class or tranche entitled to receive distributions of principal or interest according to the requirements adopted for the specific class or tranche, and includes a real estate mortgage investment conduit ("REMIC").

6 FINRA Rule 6710(k) defines "agency" to mean a United States executive agency as defined in 5 U.S.C. 105 that is authorized to issue debt directly or through a related entity, such as a government corporation, or to guarantee the repayment of principal or interest of a debt security issued by another entity. The term excludes the U.S. Department of the Treasury in the exercise of its authority to issue U.S. Treasury Securities as defined under FINRA Rule 6710(p). Under 5 U.S.C. 105, the term "executive agency" is defined to mean an "Executive department, a Government corporation, and an independent establishment."

7 FINRA Rule 6710(n) defines GSE to have the meaning set forth in 2 U.S.C. 622(8). Under 2 U.S.C. 622(8), a GSE is defined, in part, to mean a corporate entity created by a law of the United States that has a Federal charter authorized by law, is privately owned, is under the direction of a board of directors, a majority of which is elected by private owners, and, among other things, is a financial institution with power to make loans or loan guarantees for limited purposes such as to provide credit for specific borrowers or one sector and raise funds by borrowing (which does not carry the full faith and credit of the Federal Government) or to guarantee the debt of others in unlimited amounts.

8 See Item II.A.1(A)(1) infra.

trade date.[9] The agency and GSE MBS market is one of the largest fixed income markets, with approximately $5 trillion of securities outstanding and approximately $750 billion to $1.5 trillion in gross unsettled and unmargined dealer to customer transactions.[10]

Historically, the TBA market is one of the few markets where a significant portion of activity is unmargined, thereby creating a potential risk arising from counterparty exposure. Futures markets, for example, require the posting of initial margin for new positions and, for open positions, maintenance and mark to market (also referred to as "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. With a view to this gap between the TBA market versus other markets, the TMPG recommended standards (the "TMPG best practices") regarding the margining of forward-settling agency MBS transactions.[11] The TMPG Report noted that, to the extent uncleared transactions in the TBA market remain

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9 See, e.g., James Vickery & Joshua Wright, TBA Trading and Liquidity in the Agency MBS Market, Federal Reserve Bank of New York ("FRBNY") Economic Policy Review, May 2013, available at: <http://www.newyorkfed.org/research/epr/2013/1212vick.pdf>; see also SEC's Staff Report, Enhancing Disclosure in the Mortgage-Backed Securities Markets, January 2003, available at: <http://www.sec.gov/news/studies/ mortgagebacked.htm#footbody_36>.

10 See Treasury Market Practices Group ("TMPG"), Margining in Agency MBS Trading, November 2012, available at: <http://www.newyorkfed.org/tmpg/margining_tmpg_11142012.pdf> (the "TMPG Report"). The TMPG is a group of market professionals that participate in the TBA market and is sponsored by the FRBNY.

11 See TMPG, Best Practices for Treasury, Agency, Debt, and Agency Mortgage-Backed Securities Markets, revised April 4, 2014, available at: <http://www.newyorkfed.org/tmpg/bestpractices_040414.pdf>.

unmargined, these transactions "can pose significant counterparty risk to individual market participants" and that "the market's sheer size . . . raises systemic concerns."[12] The TMPG Report cautioned that defaults in this 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 clearing 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."[13]

The TMPG best practices are recommendations and as such currently are not rule requirements.[14] Unsecured credit exposures that exist in the TBA market today can lead to financial losses by dealers. Permitting counterparties to participate in the TBA market without posting margin can facilitate increased leverage by customers, thereby potentially posing a risk to the dealer extending credit and to the marketplace as a whole. Further, FINRA's present requirements do not address the TBA market generally.[15] 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

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12 See TMPG Report.

13 See note 12 supra.

14 Absent the establishment of a rule requirement, member participants have made progress in adopting the TMPG best practices. However, full adoption will take time and in the interim would leave firms at risk.

15 See Interpretations /01 through /08 of FINRA Rule 4210(e)(2)(F), available at: <http://www.finra.org/web/groups/industry/@ip/@reg/@rules/documents/industry/p122203.pdf>. 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.

establish FINRA rule requirements for the TBA market generally that will extend responsible practices to members that participate in this market.

Accordingly, to establish margin requirements for Covered Agency Transactions, FINRA is proposing to redesignate current paragraph (e)(2)(H) of Rule 4210 as new paragraph (e)(2)(I), to add new paragraph (e)(2)(H) to Rule 4210, to make conforming revisions to paragraphs (a)(13)(B)(i), (e)(2)(F), (e)(2)(G), (e)(2)(I), as redesignated by the rule change, and (f)(6),[16] and to add to the rule new Supplementary Materials .02 through .05. The proposed rule change is informed by the TMPG best practices. Further, the products the proposed amendments cover are intended to be congruent with those covered by the TMPG best practices and related updates that the TMPG has released.[17] FINRA sought comment on the proposal in a Regulatory Notice (the "Notice").[18] As discussed further in Item II.C of this filing, commenters expressed concerns that the

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16 Paragraph (e)(2) of Rule 4210, broadly, addresses margin requirements as to exempted securities, non-equity securities and baskets. As discussed further below, paragraphs (e)(2)(F) and (e)(2)(G), in combination, address specified transactions involving exempted securities, mortgage related securities, specified foreign sovereign debt securities, and investment grade debt securities. Redesignated paragraph (e)(2)(I) of the rule sets forth specified limits on net capital deductions. Paragraph (f)(6) addresses the time within which margin or mark to market must be obtained. Paragraph (a)(13)(B)(i) addresses the net worth and financial assets requirements of persons that are exempt accounts for purposes of Rule 4210.

17 See, e.g., TMPG, Frequently Asked Questions: Margining Agency MBS Transactions, June 13, 2014, available at: <http://www.newyorkfed.org/tmpg/marginingfaq06132014.pdf >; TMPG Releases Updates to Agency MBS Margining Recommendation, March 27, 2013, available at: <http://www.newyorkfed.org/tmpg/Agency%20MBS%20margining%20public%20announcement%2003-27-2013.pdf>.

18 Regulatory Notice 14-02 (January 2014) (Margin Requirements: FINRA Requests Comment on Proposed Amendments to FINRA Rule 4210 for Transactions in the TBA Market).

proposal would unnecessarily impede accustomed patterns of business activity in the TBA market, especially for smaller customers. In considering the comments, FINRA has engaged in discussions with industry participants and other regulators, including staff of the SEC and the FRBNY. In addition, as discussed in Item II.B, FINRA has engaged in analysis of the potential economic impact of the proposal. As a result, FINRA has revised the proposal as published in the Notice to ameliorate its impact on business activity and to address the concerns of smaller customers that do not pose material risk to the market as a whole, in particular those engaging in non-margined, cash account business. These revisions include among other things the establishment of an exception from the proposed margin requirements for any counterparty with gross open positions amounting to $2.5 million or less, subject to specified conditions, as well as specified exceptions to the maintenance margin requirement and modifications to the de minimis transfer provisions.

The proposed rule change, as revised in response to comment on the Notice, is set forth in further detail below.

(A) Proposed FINRA Rule 4210(e)(2)(H) (Covered Agency Transactions)

The proposed rule change is intended to reach members engaging in Covered Agency Transactions with specified counterparties. The core requirements of the proposed rule change are set forth in new paragraph (e)(2)(H).

(1) Definition of Covered Agency Transactions (Proposed FINRA Rule 4210(e)(2)(H)(i)c.

Proposed paragraph (e)(2)(H)(i)c. of the rule defines Covered Agency Transactions to mean:

- TBA transactions, as defined in FINRA Rule 6710(u),[19] inclusive of ARM transactions, for which the difference between the trade date and contractual settlement date is greater than one business day;[20]
- Specified Pool Transactions, as defined in FINRA Rule 6710(x),[21] for which the difference between the trade date and contractual settlement date is greater than one business day;[22] and
- CMOs, as defined in FINRA Rule 6710(dd),[23] issued in conformity with a program of an agency, as defined in FINRA Rule 6710(k),[24] or a GSE, as defined in FINRA Rule 6710(n),[25] for which the difference between the trade date and contractual settlement date is greater than three business days.[26]

The proposed definition of Covered Agency Transactions is largely as published in the Notice and, as discussed above, is intended to be congruent with the scope of products addressed by the TMPG best practices and related updates.[27] As further discussed in

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19 See note 3 supra.

20 See proposed FINRA Rule 4210(e)(2)(H)(i)c.1. in Exhibit 5.

21 See note 4 supra.

22 See proposed FINRA Rule 4210(e)(2)(H)(i)c.2. in Exhibit 5.

23 See note 5 supra.

24 See note 6 supra.

25 See note 7 supra.

26 See proposed FINRA Rule 4210(e)(2)(H)(i)c.3. in Exhibit 5.

27 For example, the TMPG has noted that agency multifamily and project loan securities such as Freddie Mac K Certificates, Fannie Mae Delegated Underwriting and Servicing bonds, Ginnie Mae Construction Loan/Project Loan

Item II.C.1, FINRA has been advised by the FRBNY staff that ensuring such congruence is necessary to prevent a mismatch between FINRA standards and the TMPG best practices that could result in perverse incentives in favor of non-margined products and thereby lead to distortions in trading behavior. Further, FINRA believes that congruence of product coverage helps stabilize the market by ensuring regulatory consistency.

(2) Other Key Definitions Established by the Proposed Rule Change (Proposed FINRA Rule 4210(e)(2)(H)(i))

In addition to Covered Agency Transactions, the proposed rule change establishes the following key definitions for purposes of new paragraph (e)(2)(H) of Rule 4210:

- The term "bilateral transaction" means a Covered Agency Transaction that is not cleared through a registered clearing agency as defined in paragraph (f)(2)(A)(xxviii) of Rule 4210;[28]
- The term "counterparty" means any person that enters into a Covered Agency Transaction with a member and includes a "customer" as defined in paragraph (a)(3) of Rule 4210;[29]
- The term "deficiency" means the amount of any required but uncollected

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Certificates, are all within the scope of the margining practice recommendation. See note 17 supra. The proposed definition of Covered Agency Transactions would cover these types of products as they are commonly understood to the industry.

28 See proposed FINRA Rule 4210(e)(2)(H)(i)a. in Exhibit 5. FINRA Rule 4210(f)(2)(A)(xxviii) defines registered clearing agency to mean a clearing agency as defined in SEA Section 3(a)(23) that is registered with the SEC pursuant to SEA Section 17A(b)(2).

29 See proposed FINRA Rule 4210(e)(2)(H)(i)b. in Exhibit 5.

maintenance margin and any required but uncollected mark to market loss;[30]

- The term “gross open position” means, with respect to Covered Agency Transactions, the amount of the absolute dollar value of all contracts entered into by a counterparty, in all CUSIPs; provided, however, that such amount shall be computed net of any settled position of the counterparty held at the member and deliverable under one or more of the counterparty’s contracts with the member and which the counterparty intends to deliver;[31]
- The term “maintenance margin” means margin equal to two percent of the contract value of the net long or net short position, by CUSIP, with the counterparty;[32]
- The term “mark to market loss” means the counterparty’s loss resulting from marking a Covered Agency Transaction to the market;[33]
- The term “mortgage banker” means an entity, however organized, that engages in the business of providing real estate financing collateralized by liens on such real estate;[34]
- The term “round robin” trade means any transaction or transactions resulting in equal and offsetting positions by one customer with two separate dealers for

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[30] See proposed FINRA Rule 4210(e)(2)(H)(i)d. in Exhibit 5.

[31] See proposed FINRA Rule 4210(e)(2)(H)(i)e. in Exhibit 5.

[32] See proposed FINRA Rule 4210(e)(2)(H)(i)f. in Exhibit 5.

[33] See proposed FINRA Rule 4210(e)(2)(H)(i)g. in Exhibit 5.

[34] See proposed FINRA Rule 4210(e)(2)(H)(i)h. in Exhibit 5.

the purpose of eliminating a turnaround delivery obligation by the customer;[35] and

- The term "standby" means contracts that are put options that trade OTC, as defined in paragraph (f)(2)(A)(xxvii) of Rule 4210, with initial and final confirmation procedures similar to those on forward transactions.[36]

(3) Requirements for Covered Agency Transactions (Proposed FINRA Rule 4210(e)(2)(H)(ii))

The specific requirements that would apply to Covered Agency Transactions are set forth in paragraph (e)(2)(H)(ii). These requirements address the types of counterparties that are subject to the rule, risk limit determinations, specified exceptions from the proposed margin requirements, transactions with exempt accounts,[37]

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35 See proposed FINRA Rule 4210(e)(2)(H)(i)i. in Exhibit 5.

36 See proposed FINRA Rule 4210(e)(2)(H)(i)j. in Exhibit 5. FINRA Rule 4210(f)(2)(A)(xxvii) defines the term "OTC" as used with reference to a call or put option contract to mean an over-the-counter option contract that is not traded on a national securities exchange and is issued and guaranteed by the carrying broker-dealer. The term does not include an Options Clearing Corporation ("OCC") Cleared OTC Option as defined in FINRA Rule 2360 (Options).

37 The term "exempt account" is defined under FINRA Rule 4210(a)(13). Broadly, an exempt account means a FINRA member, non-FINRA member registered broker-dealer, account that is a "designated account" under FINRA Rule 4210(a)(4) (specifically, a bank as defined under SEA Section 3(a)(6), a savings association as defined under Section 3(b) of the Federal Deposit Insurance Act, the deposits of which are insured by the Federal Deposit Insurance Corporation, an insurance company as defined under Section 2(a)(17) of the Investment Company Act, an investment company registered with the Commission under the Investment Company Act, a state or political subdivision thereof, or a pension plan or profit sharing plan subject to the Employee Retirement Income Security Act or of an agency of the United States or of a state or political subdivision thereof), and any person that has a net worth of at least $45 million and financial assets of at least $40 million for purposes of paragraphs (e)(2)(F) and (e)(2)(G) of the rule, as set forth under paragraph (a)(13)(B)(i) of Rule 4210, and meets

transactions with non-exempt accounts, the handling of de minimis transfer amounts, and the treatment of standbys.

- Counterparties Subject to the Rule

Paragraph (e)(2)(H)(ii)a. of the rule provides that all Covered Agency Transactions with any counterparty, regardless of the type of account to which booked, are subject to the provisions of paragraph (e)(2)(H) of the rule. However, paragraph (e)(2)(H)(ii)a.1. of the rule provides that with respect to Covered Agency Transactions with any counterparty that is a Federal banking agency, as defined in 12 U.S.C. 1813(z) under the Federal Deposit Insurance Act,[38] central bank, multinational central bank, foreign sovereign, multilateral development bank, or the Bank for International Settlements, a member may elect not to apply the margin requirements specified in paragraph (e)(2)(H) provided the member makes a written risk limit determination for each such counterparty that the member shall enforce pursuant to paragraph (e)(2)(H)(ii)b., as discussed below.[39]

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specified conditions as set forth under paragraph (a)(13)(B)(ii). FINRA is proposing a conforming revision to paragraph (a)(13)(B)(i) so that the phrase "for purposes of paragraphs (e)(2)(F) and (e)(2)(G)" would read "for purposes of paragraphs (e)(2)(F), (e)(2)(G) and (e)(2)(H)." See proposed FINRA Rule 4210(a)(13)(B)(i) in Exhibit 5.

38 12 U.S.C. 1813(z) defines "Federal banking agency" to mean the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, or the Federal Deposit Insurance Corporation.

39 See proposed FINRA Rule 4210(e)(2)(H)(ii)a.1. in Exhibit 5. As proposed in the Notice, central banks and other similar instrumentalities of sovereign governments would be excluded from the proposed rule's application. FINRA believes that revising the proposal so members may elect not to apply the margin requirements to such entities, provided members make and enforce the specified risk limit determinations, should help provide members flexibility to manage their risk vis-à-vis the various central banks and similar entities that participate in the

- Risk Limits

Paragraph (e)(2)(H)(ii)b. of the rule provides that members that engage in Covered Agency Transactions with any counterparty shall make a determination in writing of a risk limit for each such counterparty that the member shall enforce.[40] The rule provides that the risk limit determination shall be made by a designated credit risk officer or credit risk committee in accordance with the member's written risk policies and procedures. Further, in connection with risk limit determinations, the proposed rule establishes new Supplementary Material .05, which, in response to comment, FINRA has revised vis-à-vis the version published in the Notice.[41] The new Supplementary Material provides that, for purposes of any risk limit determination pursuant to paragraphs (e)(2)(F), (e)(2)(G)[42] or (e)(2)(H) of the rule:

  - If a member engages in transactions with advisory clients of a

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market. Further, FINRA believes the rule language, as revised, is more clear as to the types of entities with respect to which such election would be available. For further discussion, see Item II.C.7 infra.

40 FINRA has made minor revisions to the language vis-à-vis the version as published in the Notice to clarify that the member must make, and enforce, a written risk limit determination for each counterparty with which the member engages in Covered Agency Transactions.

41 FINRA believes the proposed requirement is necessary because risk limit determinations help to ensure that the member is properly monitoring its risk. FINRA believes the Supplementary Material, as revised, responds to commenter concerns by, among other things, permitting members flexibility to make the required risk limit determinations without imposing burdens at the sub-account level. For further discussion of Supplementary Material .05, as revised vis-à-vis the version published in the Notice, see Item II.C.4 infra.

42 As discussed further below, FINRA is proposing as part of this rule change revisions to paragraphs (e)(2)(F) and (e)(2)(G) of Rule 4210 to align those paragraphs with new paragraph (e)(2)(H) and otherwise make clarifying changes in light of the rule change.

registered investment adviser, the member may elect to make the risk limit determination at the investment adviser level, except with respect to any account or group of commonly controlled accounts whose assets managed by that investment adviser constitute more than 10 percent of the investment adviser's regulatory assets under management as reported on the investment adviser's most recent Form ADV;[43]

- 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;[44]
- The member may base the risk limit determination on consideration of all products involved in the member's business with the counterparty, provided the member makes a daily record of the counterparty's risk limit usage;[45] and
- A member shall consider whether the margin required pursuant to the rule is adequate with respect to a particular counterparty account or all its counterparty accounts and, where appropriate, increase such requirements.[46]

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43 See proposed FINRA Rule 4210.05(a)(1) in Exhibit 5.

44 See proposed FINRA Rule 4210.05(a)(2) in Exhibit 5.

45 See proposed FINRA Rule 4210.05(a)(3) in Exhibit 5.

46 See proposed FINRA Rule 4210.05(a)(4) in Exhibit 5.

- Exceptions from the Proposed Margin Requirements: (1) Registered Clearing Agencies; (2) Gross Open Positions of $2.5 Million or Less in Aggregate

Paragraph (e)(2)(H)(ii)c. provides that the margin requirements specified in paragraph (e)(2)(H) of the rule shall not apply to:

- Covered Agency Transactions that are cleared through a registered clearing agency, as defined in FINRA Rule 4210(f)(2)(A)(xxviii),[47] and are subject to the margin requirements of that clearing agency; and
- any counterparty that has gross open positions in Covered Agency Transactions with the member amounting to $2.5 million or less in aggregate, if the original contractual settlement for all such transactions is in the month of the trade date for such transactions or in the month succeeding the trade date for such transactions and the counterparty regularly settles its Covered Agency Transactions on a Delivery Versus Payment ("DVP") basis or for cash; provided, however, that such exception from the margin requirements shall not apply to a counterparty that, in its transactions with the member, engages in dollar rolls, as defined in FINRA Rule 6710(z),[48] or round robin trades, or that uses other financing techniques for its Covered Agency Transactions.

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[47] See note 28 supra.

[48] FINRA Rule 6710(z) defines "dollar roll" to mean a simultaneous sale and purchase of an Agency Pass-Through MBS for different settlement dates, where the initial seller agrees to take delivery, upon settlement of the re-purchase transaction, of the same or substantially similar securities.

As discussed further in Items II.B and II.C of this filing, FINRA is establishing the $2.5 million per counterparty exception to address commenter concern that the scope of Covered Agency Transactions subject to the proposed margin requirements would unnecessarily constrain non-risky business activity of market participants or otherwise unnecessarily alter participants' trading decisions. FINRA believes that transactions that fall within the proposed amount and that meet the specified conditions do not pose systemic risk. Further, many of such transactions involve smaller counterparties that do not give rise to risk to the firm. Accordingly, FINRA believes it is appropriate to establish the exception.[49]

- Transactions with Exempt Accounts

Paragraph (e)(2)(H)(ii)d. of the rule provides that, on any net long or net short position, by CUSIP, resulting from bilateral transactions with a counterparty that is an exempt account, no maintenance margin shall be required.[50] However, the rule provides

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[49] FINRA notes, however, that it is revising the provisions with respect to limits on net capital deductions as set forth in redesignated paragraph (e)(2)(I) so that amounts excepted pursuant to the $2.5 million exclusion must be included toward the concentration thresholds as set forth under new paragraph (e)(2)(I). See Item II.A.1(C) infra. FINRA believes that this is appropriate in the interest of limiting excessive risk. Further, FINRA notes that the proposed exceptions under paragraph (e)(2)(H)(ii)c. are exceptions to the margin requirements under paragraph (e)(2)(H). The requirement to determine a risk limit pursuant to paragraph (e)(2)(H)(ii)b. would apply.

[50] The proposed rule change adds to FINRA Rule 4210 new Supplementary Material .04, which provides that, for purposes of paragraph (e)(2)(H) of the rule, the determination of whether an account qualifies as an exempt account must be based upon the beneficial ownership of the account. The rule provides that sub-accounts managed by an investment adviser, where the beneficial owner is other than the investment adviser, must be margined individually. As discussed further in Item II.C.5, commenters expressed concerns regarding the proposed requirement. Supplementary Material .04 as proposed in this filing is as proposed in the Notice, as FINRA believes individual margining is fundamental sound

that such transactions must be marked to the market daily and the member must collect any net mark to market loss, unless otherwise provided under paragraph (e)(2)(H)(ii)f. of the rule.[51] The rule provides that if the mark to market loss is not satisfied by the close of business on the next business day after the business day on which the mark to market loss arises, the member shall be required to deduct the amount of the mark to market loss from net capital as provided in SEA Rule 15c3-1 until such time the mark to market loss is satisfied.[52] The rule requires that if such mark to market loss is not satisfied within five business days from the date the loss was created, the member must promptly liquidate positions to satisfy the mark to market loss, unless FINRA has specifically granted the member additional time.[53] Under the rule, members may treat mortgage bankers that use

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practice. However, in response to comment, and as further discussed in Item II.C.4, FINRA has revised the proposed rule change to provide that risk limit determinations may be made at the investment adviser level, subject to specified conditions. See discussion of Risk Limits supra.

51 As discussed further below, paragraph (e)(2)(H)(ii)f. addresses the treatment of de minimis transfer amounts.

52 FINRA has made minor revisions to the language as to timing of the specified deduction so as to better align with corresponding provisions under FINRA Rule 4210(g)(10)(A) in the context of portfolio margining.

53 See note 56 infra. Further, to conform with the proposed rule change, FINRA is revising paragraph (f)(6) of FINRA Rule 4210, which currently permits up to 15 business days for obtaining the amount of margin or mark to market, unless FINRA has specifically granted the member additional time. As revised, the phrase “other than that required under paragraph (e)(2)(H) of this Rule” would be added to paragraph (f)(6) so as to accommodate the five days specified under the proposed rule change. As discussed further in Item II.C.8 of this filing, commenters expressed concern that the specified five day period, both as to exempt accounts under paragraph (e)(2)(H)(ii)d., and as to non-exempt accounts under paragraph (e)(2)(H)(ii)e., is too aggressive. FINRA believes the five day period is appropriate in view of the potential counterparty risk in the TBA market. The rule makes express allowance for additional time, which FINRA notes is consistent with longstanding practice under current FINRA Rule 4210(f)(6).

Covered Agency Transactions to hedge their pipeline of mortgage commitments as exempt accounts for purposes of paragraph (e)(2)(H) of this Rule.[54]

- Transactions with Non-Exempt Accounts

Paragraph (e)(2)(H)(ii)e. of the rule provides that, on any net long or net short position, by CUSIP, resulting from bilateral transactions with a counterparty that is not an exempt account, maintenance margin,[55] plus any net mark to market loss on such transactions, shall be required margin, and the member shall collect the deficiency, as defined in paragraph (e)(2)(H)(i)d. of the rule, unless otherwise provided under paragraph (e)(2)(H)(ii)f. of the rule. The rule provides that if the deficiency is not satisfied by the close of business on the next business day after the business day on which the deficiency arises, the member shall be required to deduct the amount of the deficiency from net capital as provided in SEA Rule 15c3-1 until such time the deficiency is satisfied.[56]

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54 The proposed rule change adds to Rule 4210 new Supplementary Material .02, which provides that for purposes of paragraph (e)(2)(H)(ii)d. of the rule, members must adopt written procedures to monitor the mortgage banker's pipeline of mortgage loan commitments to assess whether the Covered Agency Transactions are being used for hedging purposes. This provision is largely as proposed in the Notice. Discussion of the proposed rule's potential impact on mortgage bankers is discussed further in Item II.B. The proposed requirement is appropriate to ensure that, if a mortgage banker is permitted exempt account treatment, the member has conducted sufficient due diligence to determine that the mortgage banker is hedging its pipeline of mortgage production. In this regard, FINRA notes that the current Interpretations under Rule 4210 already contemplate that members evaluate the loan servicing portfolios of counterparties that are being treated as exempt accounts. See Interpretation /02 of FINRA Rule 4210(e)(2)(F).

55 As discussed above, the proposed definition of "maintenance margin" specifies margin equal to two percent of the contract value of the net long or net short position. See proposed FINRA Rule 4210(e)(2)(H)(i)f. in Exhibit 5.

56 The proposed rule change adds to FINRA Rule 4210 new Supplementary Material .03, which provides that, for purposes of paragraph (e)(2)(H) of the rule, to the extent a mark to market loss or deficiency is cured by subsequent market

Further, the rule provides that if such deficiency is not satisfied within five business days from the date the deficiency was created, the member shall promptly liquidate positions to satisfy the deficiency, unless FINRA has specifically granted the member additional time.[57]

As discussed further in Item II.B and Item II.C of this filing, commenters expressed concern regarding the potential impact of the proposed maintenance margin requirement and its implications for non-exempt accounts versus exempt accounts. FINRA believes that the maintenance margin requirement is appropriate because it aligns with the potential risk as to non-exempt accounts engaging in Covered Agency Transactions and the specified two percent amount is consistent with other measures in this area. By the same token, to tailor the requirement more specifically to the potential risk, and to ameliorate potential burdens on market participants, FINRA has revised the proposed maintenance margin requirement vis-à-vis the version published in the Notice. Specifically, as revised, the rule provides that no maintenance margin is required if the original contractual settlement for the Covered Agency Transaction is in the month of the trade date for such transaction or in the month succeeding the trade date for such

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movements prior to the time the margin call must be met, the margin call need not be met and the position need not be liquidated; provided, however, if the mark to market loss or deficiency is not satisfied by the close of business on the next business day after the business day on which the mark to market loss or deficiency arises, the member shall be required to deduct the amount of the mark to market loss or deficiency from net capital as provided in SEA Rule 15c3-1 until such time the mark to market loss or deficiency is satisfied. See note 52 supra. FINRA believes that the proposed requirement should help provide clarity in situations where subsequent market movements cure the mark to market loss or deficiency.

[57] See notes 53 and 56 supra.

transaction and the customer regularly settles its Covered Agency Transactions on a DVP basis or for cash; provided, however, that such exception from the required maintenance margin shall not apply to a non-exempt account that, in its transactions with the member, engages in dollar rolls, as defined in FINRA Rule 6710(z), or round robin trades, as defined in proposed FINRA Rule 4210(e)(2)(H)(i)i., or that uses other financing techniques for its Covered Agency Transactions.[58]

- De Minimis Transfer Amounts

Paragraph (e)(2)(H)(ii)f. of the rule provides that any deficiency, as set forth in paragraph (e)(2)(H)(ii)e. of the rule, or mark to market losses, as set forth in paragraph (e)(2)(H)(ii)d. of the rule, with a single counterparty shall not give rise to any margin requirement, and as such need not be collected or charged to net capital, if the aggregate of such amounts with such counterparty does not exceed $250,000 ("the de minimis transfer amount"). The rule provides that the full amount of the sum of the required maintenance margin and any mark to market loss must be collected when such sum exceeds the de minimis transfer amount.

FINRA has revised the proposed de minimis transfer provisions vis-à-vis the proposal as published in the Notice. As discussed in the Notice, FINRA intends the de minimis transfer provisions to reduce potential operational burdens on members. However, some commenters expressed concerns that the provisions could among other things result in imposing forced capital charges.[59] FINRA believes that the proposal, as

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58 See Item II.B and Item II.C.2 for further discussion of the potential economic impact of the proposed requirement and comments received in response to the Notice.

59 See Item II.C.3 for further discussion.

revised, should help clarify that any deficiency or mark to market loss, as set forth under the proposed rule, with a single counterparty shall not give rise to any margin requirement, and as such need not be collected or charged to net capital, if the aggregate of such amounts with such counterparty does not exceed $250,000. FINRA believes this is appropriate because the de minimis transfer amount, by permitting members to avoid a capital charge that would otherwise be required absent the provision, is designed to help prevent smaller members from being subject to a potential competitive disadvantage and to maintain a level playing field for all members. FINRA does not believe that it is necessary for systemic safety to impose a capital charge for amounts within the specified thresholds. However, FINRA believes it is necessary to set a parameter for limiting excessive risk and as such is retaining the $250,000 amount as originally proposed in the Notice.[60]

- Unrealized Profits; Standbys

Paragraph (e)(2)(H)(ii)g. of the rule provides that unrealized profits in one Covered Agency Transaction position may offset losses from other Covered Agency Transaction positions in the same counterparty's account and the amount of net unrealized profits may be used to reduce margin requirements. With respect to standbys, only profits (in-the-money amounts), if any, on long standbys shall be recognized. The proposed language is largely as proposed in the Notice.

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60 In this regard, FINRA notes further that it is revising the provisions with respect to limits on net capital deductions as set forth in redesignated paragraph (e)(2)(I) so that the de minimis transfer amount, though it would not give rise to any margin requirement, must be included toward the concentration thresholds as set forth under the rule. See Item II.A.1(C) infra.

(B) Conforming Amendments to FINRA Rule 4210(e)(2)(F) (Transactions With Exempt Accounts Involving Certain "Good Faith" Securities) and FINRA Rule 4210(e)(2)(G) (Transactions With Exempt Accounts Involving Highly Rated Foreign Sovereign Debt Securities and Investment Grade Debt Securities)

The proposed rule change makes a number of revisions to paragraphs (e)(2)(F) and (e)(2)(G) of FINRA Rule 4210 in the interest of clarifying the rule's structure and otherwise conforming the rule in light of the proposed revisions to new paragraph (e)(2)(H) as discussed above:

- The proposed rule change revises the opening sentence of paragraph (e)(2)(F) to clarify that the paragraph's scope does not apply to Covered Agency Transactions as defined pursuant to new paragraph (e)(2)(H). Accordingly, as amended, paragraph (e)(2)(F) states: "Other than for Covered Agency Transactions as defined in paragraph (e)(2)(H) of this Rule . . ." FINRA believes that this clarification will help demarcate the treatment of products subject to paragraph (e)(2)(F) versus new paragraph (e)(2)(H). For similar reasons, the proposed rule change revises paragraph (e)(2)(G) to clarify that the paragraph's scope does not apply to a position subject to new paragraph (e)(2)(H) in addition to paragraph (e)(2)(F) as the paragraph currently states. As amended, the parenthetical in the opening sentence of the paragraph states: "([O]ther than a position subject to paragraph (e)(2)(F) or (e)(2)(H) of this Rule)."
- Current, pre-revision paragraph (e)(2)(H)(i) provides that members must maintain a written risk analysis methodology for assessing the amount of

credit extended to exempt accounts pursuant to paragraphs (e)(2)(F) and (e)(2)(G) of the rule which shall be made available to FINRA upon request. The proposed rule change places this language in paragraphs (e)(2)(F) and (e)(2)(G) and deletes it from its current location. Accordingly, FINRA proposes to move to paragraphs (e)(2)(F) and (e)(2)(G): "Members shall maintain a written risk analysis methodology for assessing the amount of credit extended to exempt accounts pursuant to [this paragraph], which shall be made available to FINRA upon request." Further, FINRA proposes to add to each: "The risk limit determination shall be made by a designated credit risk officer or credit risk committee in accordance with the member's written risk policies and procedures."[61] FINRA believes this amendment makes the risk limit determination language in paragraphs (e)(2)(F) and (e)(2)(G) more congruent with the corresponding language proposed for new paragraph (e)(2)(H) of the rule.

- The proposed rule change revises the references in paragraphs (e)(2)(F) and (e)(2)(G) to the limits on net capital deductions as set forth in current paragraph (e)(2)(H) to read "paragraph (e)(2)(I)" in conformity with that paragraph's redesignation pursuant to the rule change.

(C) Redesignated Paragraph (e)(2)(I) (Limits on Net Capital Deductions)

Under current paragraph (e)(2)(H) of FINRA Rule 4210, in brief, a member must provide prompt written notice to FINRA and is prohibited from entering into any new transactions that could increase the member's specified credit exposure if net capital

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61 See proposed FINRA Rule 4210(e)(2)(F) and Rule 4210(e)(2)(G) in Exhibit 5.

deductions taken by the member as a result of marked to the market losses incurred under paragraphs (e)(2)(F) and (e)(2)(G), over a five day business period, exceed: (1) for a single account or group of commonly controlled accounts, five percent of the member's tentative net capital (as defined in SEA Rule 15c3-1); or (2) for all accounts combined, 25 percent of the member's tentative net capital (again, as defined in SEA Rule 15c3-1). As discussed earlier, the proposed rule change redesignates current paragraph (e)(2)(H) of the rule as paragraph (e)(2)(I), deletes current paragraph (e)(2)(H)(i), and makes conforming revisions to paragraph (e)(2)(I), as redesignated, for the purpose of clarifying that the provisions of that paragraph are meant to include Covered Agency Transactions as set forth in new paragraph (e)(2)(H). In addition, the proposed rule change clarifies that de minimis transfer amounts must be included toward the five percent and 25 percent thresholds as specified in the rule, as well as amounts pursuant to the specified exception under paragraph (e)(2)(H) for gross open positions of $2.5 million or less in aggregate.[62]

Accordingly, as revised by the rule change, redesignated paragraph (e)(2)(I) of the rule provides that, in the event that the net capital deductions taken by a member as a result of deficiencies or marked to the market losses incurred under paragraphs (e)(2)(F) and (e)(2)(G) of the rule (exclusive of the percentage requirements established thereunder), plus any mark to market loss as set forth under paragraph (e)(2)(H)(ii)d. of the rule and any deficiency as set forth under paragraph (e)(2)(H)(ii)e. of the rule, and inclusive of all amounts excepted from margin requirements as set forth under paragraph (e)(2)(H)(ii)c.2. of the rule or any de minimis transfer amount as set forth under

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62 As discussed earlier, FINRA believes that inclusion of the de minimis transfer amounts and amounts pursuant to the $2.5 million per counterparty exception is appropriate in view of the rule's purpose of limiting excessive risk.

paragraph (e)(2)(H)(ii)f. of the rule, exceed:

- for any one account or group of commonly controlled accounts, 5 percent of the member's tentative net capital (as such term is defined in SEA Rule 15c3-1),[63] or
- for all accounts combined, 25 percent of the member's tentative net capital (as such term is defined in SEA Rule 15c3-1),[64] and,
- such excess as calculated in paragraphs (e)(2)(I)(i)a. or b. of the rule continues to exist on the fifth business day after it was incurred,[65]

the member must give prompt written notice to FINRA and shall not enter into any new transaction(s) subject to the provisions of paragraphs (e)(2)(F), (e)(2)(G) or (e)(2)(H) of the rule that would result in an increase in the amount of such excess under, as applicable, paragraph (e)(2)(I)(i) of the rule.

If the Commission approves the proposed rule change, FINRA will announce the effective date of the proposed rule change in a Regulatory Notice to be published no later than 60 days following Commission approval. The effective date will be no later than 180 days following publication of the Regulatory Notice announcing Commission approval.

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63 See proposed FINRA Rule 4210(e)(2)(I)(i)a. in Exhibit 5.

64 See proposed FINRA Rule 4210(e)(2)(I)(i)b. in Exhibit 5.

65 See proposed FINRA Rule 4210(e)(2)(I)(i)c. in Exhibit 5.

2. Statutory Basis

FINRA believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,[66] which requires, among other things, that FINRA rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. FINRA believes that the proposed rule change is consistent with the Act because, by establishing margin requirements for Covered Agency Transactions (the TBA market), the proposed rule change will help to reduce the risk of loss due to counterparty failure in one of the largest fixed income markets and thereby help protect investors and the public interest by ensuring orderly and stable markets. As FINRA has noted, unsecured credit exposures that exist in the TBA market today can lead to financial losses by members. Permitting members to deal with counterparties in the TBA market without collecting margin can facilitate increased leverage by customers, thereby potentially posing a risk to FINRA members that extend credit and to the marketplace as a whole. FINRA believes that, 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, particularly since the financial crises of 2008 and 2009, and in light of regulatory efforts to enhance risk controls in related markets, there is a need to establish FINRA rule requirements that will extend responsible practices to all members that participate in the TBA market. In preparing this rule filing, FINRA has undertaken economic analysis of the proposed rule change's potential impact and has made revisions to the proposed rule change, vis-à-vis the version as originally published in Regulatory Notice 14-02, so as to

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[66] 15 U.S.C. 78o-3(b)(6).

ameliorate the proposed rule change's impact on business activity and to address the concerns of smaller customers that do not pose material risk to the market as a whole. These revisions include among other things the establishment of an exception from the proposed margin requirements for any counterparty with gross open positions amounting to $2.5 million or less, subject to specified conditions, as well as specified exceptions to the proposed maintenance margin requirement and modifications to the de minimis transfer provisions.

B. Self-Regulatory Organization's Statement on Burden on Competition

FINRA does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act. As discussed above, FINRA published Regulatory Notice 14-02 (January 2014) (the "Notice") to request comment[67] on proposed amendments to FINRA Rule 4210 to establish margin requirements for transactions in the TBA market. FINRA noted that the proposal is informed by the TMPG best practices.

The proposed rule change aims to reduce firm exposure to counterparty credit risk stemming from unsecured credit exposure that exists in the market today. A significant portion of the TBA market is non-centrally cleared, exposing parties extending credit in a transaction to significant counterparty risk between trade and settlement dates.[68] To the extent that the proposed rule change encourages better risk management practices, the

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[67] All references to commenters are to commenters as listed in Exhibit 2b and as further discussed in Item II.C of this filing.

[68] See, e.g., TMPG Recommends Margining of Agency MBS Transactions to Reduce Counterparty and Systemic Risks, November 14, 2012, available at: <http://www.newyorkfed.org/tmpg/marginambs.pdf >; see also TMPG Report.

loss given default by a counterparty with substantial positions in Covered Agency Transactions should decrease.

The unmargined positions in the TBA market may also raise systemic concerns. Were one or more counterparties to default, the interconnectedness and concentration in the TBA market may lead to potentially broadening losses and the possibility of substantial disruption to financial markets and participants.

The repercussions of unmargined bilateral credit exposures were demonstrated in the Bear Stearns and Lehman Brothers failures in 2008. Since the financial crisis of 2008-09, margining regimes on bilateral credit transactions have been strengthened by regulatory bodies and adopted as a part of best practices by industry groups. For example, margining has become a widespread practice – especially after the adoption of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act)[69] – in repurchase agreements, securities lending and derivatives markets.[70] Thus, the lack of mandatory margining currently between dealers and their customers in the TBA market is out of step with regulatory developments in other markets with forward settlements. To address this gap, TMPG urged implementation of its margining recommendations by the end of 2013.[71]

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[69] Pub. L. No. 111-203, 124 Stat. 1376 (2010).

[70] <u>See</u> Bank for International Settlements, Margin Requirements for Non-centrally Cleared Derivatives – Final Report Issued by the Basel Committee and IOSCO, September 2, 2013, available at: <http://www.bis.org/press/p130902.htm>.

[71] <u>See</u> TMPG Releases Updates to Agency MBS Margining Recommendation, March 27, 2013, available at: <http://www.newyorkfed.org/tmpg/ Agency%20MBS% 20margining%20public% 20announcement%2003-27-2013.pdf>.

As discussed above, the proposed rule change would require member firms to collect, as to exempt accounts, mark to market margin and, as to non-exempt accounts, both mark to market margin and maintenance margin, as specified by the rule. Based on discussions with industry participants, FINRA expects that very few accounts would be treated as non-exempt accounts under the rule, and hence most would not be subject to the maintenance margin requirement.[72] Therefore, the economic impact assessment as set forth below is centered on the impact of the proposed mark to market margin.

1. Economic Baseline

To better understand the TBA market, FINRA analyzed data from two sources. The first dataset contains approximately 2.06 million TBA market transactions reported to TRACE by 223 broker-dealers from March 1, 2012 to July 31, 2013. Of the 2.06 million trades, approximately 1.10 million were interdealer trades, and 960,000 were

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[72] As discussed above, the proposed rule permits members to treat mortgage bankers that use Covered Agency Transactions to hedge their pipeline of mortgage commitments as exempt accounts for purposes of the rule. Based on discussions with industry participants, FINRA believes that a great majority of mortgage bankers transact in the market to hedge their loans, and engage in very little speculative trading. While TRACE data do not identify the motivation for the trade to validate this statement, FINRA understands, based on discussions with market participants, that most Covered Agency Transactions will be excepted from the proposed maintenance margin requirement.

dealer-to-customer trades.[73] Approximately 26.65% of the interdealer trades and 28.87% of the dealer-to-customer trades were designated as dollar rolls, a funding mechanism in which there is a simultaneous sale and purchase of an Agency Pass-Through Mortgage-Backed Security with different settlement dates. The mean trade size was $19.33 million (the median was $19.34 million) and the median daily trading volume was $199 billion, totaling $49.3 trillion annually. The mean difference between the trade and contractual settlement date was 29.5 days (the median was 26 days).

Based on FINRA's analysis of the transactions in the TRACE dataset, market participation by broker-dealers is highly concentrated, as the top ten broker-dealers account for more than approximately 77% of the dollar trading volume in the trades analyzed. These are primarily broker-dealers affiliated with large bank holding companies and include FINRA's ten largest members. Five are members of the TMPG.[74] Non-FINRA members are not required to report transactions in TRACE.

FINRA understands that most interdealer transactions in the TBA market are subject to mark to market margin between members of the Mortgage-Backed Securities Division ("MBSD") of the Fixed Income Clearing Corporation ("FICC," a subsidiary of

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73 FINRA understands that dealer-to-customer trades in the TRACE data include a significant volume of transactions where the broker dealer is counterparty to the FRBNY. While such trades are not directly distinguishable within the data from other dealer-to-customer trades in TRACE, the FRBNY publishes a list of its transactions available at: <http://www.newyorkfed.org/markets/ambs/ambs_schedule.html>. Based on this public information, FINRA estimates that the FRBNY transacted in 44 of the 2,677 distinct CUSIPs reported in TRACE, and accounted for 1.63% of the overall trades in the sample. However, FRBNY trades are quite large in size, and account for, on average, 24.80% of the daily volume for those CUSIPs on the days it trades.

74 Besides broker-dealers, TMPG members also include banks, buy-side firms, market utilities, foreign central banks, and others.

the Depository Trust & Clearing Corporation ("DTCC")), which acts as a central counterparty. Also, FINRA understands that, as of June, 2014, TMPG member firms had, on average, margining agreements with approximately 65% of their counterparties.[75] FINRA understands that these firms' activities account for approximately 70% of transactions in the TBA market, and 85% of notional trading volume. However, full adoption of mark to market margining practices by TMPG member firms is yet to be achieved. The lack of market-wide adoption of margin practices may put some market participants at a disadvantage, as they incur the costs associated with implementation of mark to market margin, while unmargined participants are able to transact at lower economic cost.

To assess the likely impact of the proposal, FINRA estimated the daily margin requirement that broker-dealers and their customers would have had to post under the proposed requirement, using transaction data in the TBA market that are available from TRACE and were made available by a major clearing broker. FINRA notes that there are several limitations to the analysis due to data availability. Among these, the data are not granular enough to contain sufficient detail on contractual settlement terms, with respect to which the proposed rule change establishes parameters for specified exceptions to apply,[76] or as to whether the trade is a specified financing trade (we note that, other than

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75 See TMPG Meeting Minutes, June 25, 2014, available at: <http://www.newyorkfed. org/tmpg/june_minutes_2014.pdf>.

76 To recap, the rule's margin requirements would not apply to any counterparty that has gross open positions in Covered Agency Transactions amounting to $2.5 million or less in aggregate, if the original contractual settlement for all such transactions is in the month of the trade date for such transactions or in the month succeeding the trade date for such transactions and the counterparty regularly

dollar roll trades, TRACE does not require a special code for round robin, repurchase or reverse repurchase, or financing trades), with respect to which specified exceptions under the proposal are not available.[77] Therefore, FINRA notes that it is able to make only limited inference about the current level of trading that would be subject to the specified exceptions. Moreover, unique customer identity is not available in TRACE, meaning FINRA is unable to assess the activities in individual accounts to determine which, if any, exceptions might apply.

The second dataset, containing TBA transactions, was provided to FINRA by a major clearing broker and contains 5,201 open positions as of May 30, 2014, in 375 customer accounts from ten introducing broker-dealers. These data represent 4,211 open short positions and 990 open long positions. The mean sizes for long and short positions were \$2.02 million and \$1.69 million, respectively, while the median open position size was \$1.00 million for both long and short positions. In the sample, an account had a mean of 13.87 open positions (a median of 10) where the mean gross exposure was \$24.31 million (a median of \$12 million). This dataset enables FINRA to make inferences about the potential margin obligations that individual customer accounts would incur, which is not possible using TRACE, since unique customer identifications are not available. As such, these customer accounts may provide better understanding of

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settles its Covered Agency Transactions DVP or for cash, subject to specified conditions. See proposed FINRA Rule 4210(e)(2)(H)(ii)c.2. in Exhibit 5.

77 To recap, the \$2.5 million per counterparty exception and, with respect to non-exempt accounts, the proposed relief from maintenance margin, are not available to a counterparty that, in its transactions with the member, engages in dollar rolls or round robin trades, or that uses other financing techniques for its Covered Agency Transactions. See proposed FINRA Rule 4210(e)(2)(H)(ii)c.2. and Rule 4210(e)(2)(H)(ii)e. in Exhibit 5.

customer, particularly mortgage banker, activity. However, the data do not identify whether trades include a special financing technique, such as dollar roll or other financing techniques, or whether the trades are settled DVP or for cash.

2. Economic Impact

The proposed rule change is expected to enhance sound risk management practices for all parties involved in the TBA market. Further, the standardization of margining practice should create a fairer environment for all market participants. Ultimately, the proposed rule change is expected to mitigate counterparty risk to protect both sides to a transaction from a potential default.

As discussed earlier, FINRA has made revisions to the proposed rule change as published in the Notice to ameliorate the proposal's impact on business activity and to address the concerns of smaller customers that do not pose material risk to the market as a whole, in particular those engaging in non-margined, cash only business. After considering comments received in response to the Notice, as well as extensive discussions with industry participants and other regulators, FINRA's proposed revisions include among other things the establishment of an exception from the proposed margin requirements for any counterparty with gross open positions amounting to $2.5 million or less, subject to specified conditions, as well as specified exceptions to the maintenance margin requirement and modifications to the de minimis transfer provisions.

FINRA understands that there will likely be direct and indirect costs of compliance associated with the proposed rule change as revised. Some of the direct costs are largely fixed in nature, and mostly include initial start-up costs, such as acquiring systems, software or technical support, and allocating staff resources to manage a margining regime. Direct costs would also entail developing necessary procedures and establishing monitoring mechanisms. FINRA anticipates that a significant cost of the proposed rule change is the commitment of capital to meet the margin requirements. The magnitude of this cost depends on the trading activity of each party, each party's access to capital, and each party's having the capital reserves necessary to fulfill margin obligations. FINRA's experience with supervision of risk controls at larger firms suggests that at present substantially all such firms have systems in place for managing the margining of Covered Agency Transactions, and thus the system costs of the proposed rule change would result from extending the systems to the margining of transactions covered by the proposed rule change for those firms. In addition, as discussed above, FINRA understands that TMPG members at present require a substantial portion of their counterparties to post mark to market margin, implying that those firms should already have the systems and staff to facilitate margining practices and manage capital allocated. Therefore, FINRA believes that most start-up costs are likely to be incurred by smaller market participants that might have to establish the necessary systems for the first time.

FINRA understands that the margin requirements for TBA market transactions may also impose indirect costs. These costs may result from changed market behavior of some participants. Some parties who currently transact in the TBA market may choose to withdraw from or limit their participation in the TBA market. Reduced participation may lead to decreased liquidity in the market for certain issues or settlement periods, potentially restricting access to end users and increasing costs in the mortgage market. These market-wide impacts on liquidity would be limited if exiting market participants represent a small proportion of market transactions while market participants that choose to remain, or new participants that choose to enter the market, increase their activities and thereby offset the impact of participants that exit the market.

The potential impacts of the proposed rule change on mortgage bankers, broker-dealers, investors and consumers of mortgages are discussed in turn below.

(a) Mortgage Bankers

Based on discussions with market participants and other regulators, FINRA understands that mortgage bankers are among the largest group of customers in the TBA market – following institutional buyers – as the forward-settling nature of MBS transactions provides mortgage bankers with the opportunity to lock in interest rates as new loans are originated. These transactions give mortgage lenders an opportunity to hedge their exposures to interest rate risk between the time of origination and the sale of the home loan in the secondary market.

To estimate the potential burden on mortgage bankers, FINRA analyzed the data described above that was provided by a major clearing broker. As discussed earlier, the proposed rule change establishes a $250,000 de minimis transfer amount below which the member need not collect margin, subject to specified conditions,[78] and establishes an exception from the proposed margin requirements for any counterparty with gross open positions amounting to $2.5 million or less, subject to specified conditions.[79] FINRA believes that it may reasonably estimate the trades that would be subject to the $2.5 million per counterparty exception in the sample even though information describing the

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78 See proposed FINRA Rule 4210(e)(2)(H)(ii)f. in Exhibit 5.

79 See proposed FINRA Rule 4210(e)(2)(H)(ii)c.2. in Exhibit 5.

specified contractual settlement terms that are elements of the exception are not available.[80]

For these data, FINRA finds that only nine of the 375 accounts would have an obligation to post margin on a total of 35 days for their open positions as of May 30, 2014 if subject to the proposed rule change. By this analysis, less than 0.01% of the 14,001 account-day combinations in the sample would be required to provide margin on their TBA positions. For those accounts that would be required to post margin on any day during the period studied, FINRA estimates the average (median) net daily margin to be posted on these 35 days to be $595,191 ($384,180) for an average (median) gross exposure of $246,901,235 ($253,111,500).[81] The ratio of the estimated margin to the gross exposure ranges between 0.06% and 4.34% and has a mean (median) of 0.54% (0.29%). The gross positions across all days studied for the remaining 366 accounts

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80 For purposes of this analysis, FINRA assumes that these positions include no financing trades, and thus all aggregate positions with a single counterparty under the $2.5 million threshold would be excepted from the mark to market margining requirements. FINRA considers this assumption as reasonable because FINRA understands from subject matter experts that mortgage bankers do not traditionally employ TBA contracts for financing. Further, this assumption does not materially affect estimates of margin obligation under the rule, since only a few positions would have to post margin due to the $250,000 de minimis transfer amount exception.

81 For a given customer account at a broker-dealer, margin (assuming the application of mark to market margin) is computed for each net long or short position, by CUSIP, in Covered Agency Transactions by multiplying the net long or short contract amount by the daily price change. The margin for all Covered Agency Transactions is the sum of the margin required on each net long or net short position. On the day following the start of the contract, the price change is measured as the difference between the original contract price and the end of day closing price.

result in an estimated mark to market obligation that is less than the de minimis transfer amount, and hence no obligations would be incurred.

To the extent that the sample considered in this analysis is representative, it appears that mortgage bankers have smaller gross exposures, on average, and more positions that would generate margin obligations that are less than the $250,000 de minimis transfer amount. Accordingly, FINRA expects that the majority of the mortgage bankers' positions would be excepted from the proposed margin requirements.

The Notice invited commenters to provide information concerning the potential costs and burdens that the amendments could impose. As discussed earlier, the proposed rule change would permit members to treat mortgage bankers that use Covered Agency Transactions to hedge their pipeline of mortgage commitments as exempt accounts. Members would be required to adopt procedures to monitor the mortgage banker's pipeline of mortgage loan commitments to assess whether the Covered Agency Transactions are being used for hedging purposes.[82] Some commenters in response to the Notice expressed concern that this would harm the ability of mortgage bankers to compete. Commenters suggested that mortgage bankers should be permitted flexibility to negotiate their margin obligations, that they should be treated as exempt accounts regardless of the extent to which they are hedging, that monitoring hedging by mortgage bankers would be too burdensome, that the costs of compliance would drive mortgage bankers to shift to non-FINRA member counterparties, that margin requirements should

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[82] See proposed FINRA Rule 4210(e)(2)(H)(ii)d. and Rule 4210.02 in Exhibit 5.

be modified to reflect the costs of hedging, and that the $250,000 de minimis transfer threshold would be too restrictive.[83]

In response, FINRA understands the importance of the role of mortgage bankers in the mortgage finance market and for that reason designed the proposed rule change to include the provision for members to treat mortgage bankers as exempt accounts with respect to their hedging. However, FINRA believes that it would work against the rule's overall purposes to create a pathway for a mortgage banker that is not otherwise an exempt account to engage in speculation in the TBA market, which could create incentives leading to distortions in trading behavior. In the presence of such incentives, FINRA believes it reasonable to expect a party to more frequently enter into transactions that are primarily speculative in nature. In fact, where other market participants would be constrained by the rule, these types of transactions might be more profitable than they are today. As noted earlier, the proposed rule change accommodates the business of mortgage bankers by providing exempt account treatment to the extent the member has conducted sufficient due diligence to determine that the mortgage banker is hedging its pipeline of mortgage production. Again, as discussed earlier, FINRA notes that the current Interpretations under Rule 4210 already contemplate that members evaluate the loan servicing portfolios of counterparties that are being treated as exempt accounts.[84]

(b) Broker-Dealers

FINRA believes that currently broker-dealers are the main providers of liquidity in the TBA market and their trading behavior impacts nearly all market participants.

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83 Baum, BB&T, BDA, Brean, Duncan-Williams, MBA, MountainView, Shearman and SIFMA.

84 See note 54 supra.

While the direct costs of margin requirements will be similar to those of mortgage bankers, the initial costs are likely much lower in aggregate as many of these firms have systems in place to manage margining practices.

FINRA understands that, currently, there are 153 members of MBSD that already follow mark to market margining procedures required by MBSD. Of those 153 firms, 38 are FINRA members, including the ten most active broker-dealers in the TBA market, who collectively account for approximately 77% of the dollar trading volume reported in TRACE. FINRA believes that start-up costs will likely be incurred by smaller and regional members that are not MBSD members. Some of these smaller and regional firms may already be in the process of establishing in-house solutions or outsourcing margining management in order to follow the TMPG recommendations.

FINRA computed bilateral interdealer TBA exposures using approximately 1.10 million TBA trades between March 1, 2012 and July 31, 2013 reported to TRACE and estimated the mark to market margin that counterparties would have been required to post if the proposed margin requirements existed during the sample period. The mean (median) interdealer trade size is $33.98 million ($5.31) and the mean difference between the trade date and contractual settlement date is 25.2 days (20 days).[85] Estimated margin obligations below the $250,000 de minimis transfer amount account for approximately 85.68% of all transactions. This result suggests that a great majority of the aggregate gross exposures held by broker-dealers could be excepted from the proposed margin

85 For dollar roll transactions, the mean trade size is $76.56 million (a median of $21.01 million), whereas, for non-financing transactions, the mean trade size is $20.28 million (a median of $5.18 million).

requirements, subject to specified conditions.[86] As expected, broker-dealers with relatively smaller aggregate exposures in the TBA market have a relatively larger share of their transactions that would be subject to the de minimis transfer exception.[87]

TRACE has a specific flag that identifies certain transactions as dollar rolls, a type of financing trade to which specified exceptions under the proposed rule change are not available. But dollar rolls are not the only type of financing trades specified under the proposed rule. Therefore, the analysis above potentially underestimates the number and dollar value of transactions that would be subject to both maintenance and mark to market margin if held in non-exempt accounts under the proposed rule.

Using the same method employed above,[88] FINRA estimates that approximately half of the broker-dealers transacting in the TBA market would not have to post mark to market margin throughout the sample period due to the de minimis transfer amount exception. Of the remaining broker-dealers, 38% would have to post margin on less than 10% of the days for which they hold non-zero aggregate gross exposures. The remaining 12% would have to post margin on more than 10% of the days for which they hold non-zero aggregate gross exposure, although none of these broker-dealers would have had a mark to market margin requirement for more than 37.5% of the days for which they held non-zero aggregate gross exposures. In the sample of broker-dealers that would incur

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86 FINRA understands that a significant portion of the interdealer trades go through MBSD.

87 For purposes of the analysis, FINRA sorted broker-dealers in descending order based on their aggregate positions and analyzed them in two subsamples. On average, approximately 99% of the aggregate gross exposures of smaller broker-dealers (the half with smaller aggregate positions) would result in a margin obligation below the $250,000 threshold.

88 See note 81 supra for the margin calculation methodology.

margin obligation, a broker-dealer would be required to post an average (median) daily margin of $84,748 ($0) for an average (median) gross exposure of $1.29 billion ($68.68 million). When the analysis is limited to the days that margin obligations would be incurred under the rule, the average (median) margin obligation to be posted to a counterparty is estimated to be $1.14 million ($591,952) for an average (median) exposure of $5.71 billion ($2.07 billion) and accounts for approximately 0.02% of the aggregate gross exposure value. Based on the entire sample, FINRA estimates that a broker-dealer would incur an average (median) monthly margin obligation of $24,235,867 ($0) for an average (median) aggregate gross counterparty exposure of approximately $16.47 billion ($239 million). When the analysis is limited to those broker-dealers that would have incurred a margin obligation under the rule in the sample period, the average (median) monthly margin obligation would be approximately $33.76 million ($1.29 million) for an average (median) aggregate gross exposure of $22 billion ($777 million). The sizeable differences between average and median values reported here are due to a few large broker-dealer positions in the sample.

In response to the Notice, some commenters expressed concern that the amendments would place small and mid-sized broker-dealers at a disadvantage. Specifically, commenters suggested that smaller firms have limited resources to meet the anticipated compliance costs, that costs would fall disproportionately on smaller firms that are active in the MBS and CMO markets, that business would shift to non-FINRA members, that the proposal unfairly favors larger or “too big to fail” firms with easier access to resources, that the proposal would result in consolidation of the industry, that the system and infrastructure costs faced by smaller firms would be prohibitive, and that they have never observed a degradation in value of the products between trade date and settlement date.[89] Some commenters suggested such costs as: up to $500 per account for compliance; an outlay of $600,000 to purchase necessary software; payments of up to $100,000 in annual fees; payments of up to $400,000 in outsourcing costs; total costs of up to $1 million per year; or, according to one commenter, system costs as high as $15 million per year.[90]

FINRA is sensitive to the concerns expressed by firms. However, as discussed earlier, FINRA believes that to assert that no degradation has been observed in the TBA market (other than that associated with the collapse of Lehman) does not of itself demonstrate that there is no credit risk in this market. TBA market participants have exposure to significant counterparty credit risk, defined as the potential failure of the counterparty to meet its financial obligations.[91] The lack of margining and proper risk management can lead to a buildup of significant counterparty exposure, which can create correlated defaults in the case of a systemic event. While the implementation of the proposed requirements creates a regulatory cost, incurred by establishing or updating systems for the management of margin accounts, the benefits should accrue over time and help maintain a properly functioning retail mortgage market even in stressed market conditions. FINRA believes that this, in turn, should help create a more stable business environment that should benefit all market participants.

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[89] Ambassador, Baird, BB&T, BDA, Brean, Clarke, Duncan-Williams, FirstSouthwest, Mischler, Pershing, Shearman, SIFMA and Simmons.

[90] Baird, Baum, BDA, Clarke and Sandler.

[91] Counterparty credit risk increases axiomatically during volatile market conditions, as recently experienced in the TBA market in the summer of 2011.

With respect to the specific cost amounts suggested by commenters, FINRA notes that, though compliance with the proposed amendments will involve regulatory costs, as noted above, most of these would be incurred as variable costs as margin obligations or fixed startup costs for purchase or upgrading of software. FINRA believes, based on discussions with providers, that the proffered estimates by commenters are plausible but fall towards the higher end of the cost range for building, upgrading or outsourcing the necessary systems. Further, FINRA believes that, particularly for smaller firms, the proposed $250,000 de minimis amount and $2.5 million per counterparty exception should serve to mitigate these costs.

(c) Retail Customers and Consumers

In response to the Notice, some commenters expressed concern that the amendments would result in higher costs to retail customers who participate in the MBS and CMO market. Commenters suggested that recordkeeping costs for investors with exposures to these securities would increase significantly; these increased costs would likely disincline them to participate in the market; and that those who wanted to maintain their exposure would face liquidity constraints in posting margin.[92] On the other hand, one commenter did not agree that impact on retail customers would be significant as they rarely trade in the TBA market on a forward-settlement basis.[93]

In response, FINRA notes that the purpose of the margin rules is to protect the market participants from losses that could stem from increased volatility and the ripple effects of failures. This is a by-product that provides direct protection to the customers of

92 Ambassador, Baum, BDA and Coastal.

93 BB&T.

members.[94] Margin requirements protect other customers of a member firm from the speculation and losses of other large customers.

Other commenters drew attention to potential negative impacts to the consumer market, suggesting that the amendments would chill the mortgage market and impose liquidity constraints because mortgage bankers would face higher costs that would be passed on to consumers of mortgages.[95] However, FINRA notes that there is mixed evidence regarding the impact of margin requirements on trading volume and market liquidity. For instance, in one of the earlier studies, researchers found that margin requirements negatively affect trading volume in the futures market, a finding consistent with expectations from theory.[96] More recently, other researchers have provided evidence from a foreign derivatives market that margin has no impact on trading volume.[97] Thus, claims that the margin requirement will have a negative impact on market activity, and hence on mortgage rates, are not fully supported by empirical findings in other similar markets.

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[94] See discussion of the original objectives of margin regulation in Jules I. Bogen & Herman Edward Krooss, Security Credit: Its Economic Role and Regulation 88–89 (Englewood Cliffs, NJ Prentice-Hall 1960).

[95] MBA and MetLife.

[96] See Hans R. Dutt & Ira L. Wein, Revisiting the Empirical Estimation of the Effect of Margin Changes on Futures Trading Volume, 23 The Journal of Futures Markets, (Issue 6) 561–76 (2003).

[97] See Kate Phylaktis & Antonis Aristidou, Margin Changes and Futures Trading Activity: A New Approach, 19 European Financial Management, (Issue 1) 45–71 (2013).

3. Interest Rate Volatility and Margin Requirements

The historically low and stable interest rates that the United States has experienced over the last several years might lead FINRA to underestimate the margin that market participants would have to post in a more volatile market, and thus underestimate the impact of the rule proposal.

To assess the likely impact of the rule on the margin obligation in a more volatile interest rate environment, FINRA has estimated the volatility[98] in the TBA market across two periods with different interest rate characteristics, relying on Deutsche Bank's TBA index.[99] The first period that FINRA analyzed is from July 1, 2012, to June 30, 2014. The average yield on the 10-year U.S. Treasury note in this period was measured at 2.25%. The second period FINRA analyzed is from June 1, 2004 to May 31, 2006. This second period was marked by a substantially higher average 10-year U.S. Treasury yield, measured at 4.14%. However, FINRA estimates the volatility in the TBA index to have been effectively the same, at 3.95%, in both periods. FINRA believes this analysis suggests that volatility in the TBA market is not expected to significantly increase if interest rates increase in the future.[100] Therefore, a margin obligation for broker-dealers

98 For purposes of this section, volatility refers to the standard deviation, statistically computed, of the distribution of a dataset.

99 For further information, see DB US Mortgage TBA Index, available at: <https:// index.db.com/servlet/MBSHome>.

100 Alternatively, FINRA compared the first period with another, even more volatile interest rate environment, from June 1, 1999 to May 31, 2000, during which the average yield on the 10-year Treasury note was 6.14%. FINRA estimates that the volatility of the TBA index in that period was 4.30%, suggesting that volatility in the TBA market would not be expected to significantly increase in a more volatile interest rate environment.

of approximately 2% of the contract value over the life of a TBA market security appears to be a reasonable estimate.

4. Indirect Costs of the Proposed Margin Requirements

There are several provisions in the proposal that may potentially alter market participants' behavior in order to minimize the anticipated costs associated with the proposed rule. Such changes in behavior could potentially make trading more difficult for some settlement periods or contract sizes.

As proposed in the Notice, the proposed rule change provides a $250,000 de minimis transfer amount below which the member need not collect margin, subject to specified conditions. FINRA notes that this might create an incentive to trade contract sizes smaller than the threshold amount by splitting large contracts into contracts with smaller sizes. This behavior can potentially make larger contracts harder to trade, and hence decrease liquidity in such trades. FINRA does not anticipate that such a reaction would impact the total liquidity in the TBA market. Rather, the impact could manifest itself in increased transaction costs for trading a larger position in smaller lots.

With respect to the $2.5 million per counterparty exception, FINRA notes that the parameters for the settlement periods specified in the proposed rule may create an incentive to time trading (so that the original contractual settlement is in the month of the trade date or in the month succeeding the trade date, as provided in the rule) and thereby alter trading patterns in order to avoid margin obligations. For example, FINRA identified 582,435 trades from TRACE where the difference between the settlement date and the trade date is longer than 30 days but less than 61 days. Assuming that these trades meet all other conditions specified in the rule, approximately 78% of them would qualify for the $2.5 million per counterparty by virtue of settling within the specified timeframes. In the presence of the proposed rule, FINRA anticipates that some traders might alter the timing of their trades, others might incur higher costs to achieve the same economic exposure, and others yet might choose not to enter into trades with those costs.

As discussed further in Item II.C of this filing, some commenters in response to the Notice suggested that market participants, in response to the costs imposed by the rule, might shift their trades to other counterparties that are not required by regulation to collect margin.[101] As discussed above, there are significant efforts among TMPG institutions to impose mark to market margin on these transactions. Based on discussions with market participants, FINRA understands, as discussed earlier, that members of the TMPG have begun imposing mark to market margin requirements on some of their clients in order to adhere to the best practices suggested by the group. However, FINRA understands, based on the TMPG Report, that the daily average customer-to-dealer transaction volume is around $100 billion, of which approximately two-thirds is unmargined.[102] FINRA also understands that there is a small number of financial institutions that currently deal in the TBA market but are not broker-dealers or members of TMPG. FINRA anticipates that there would be limited scope for such institutions to participate in the TBA market on a large scale without facing a counterparty that would require margin. FINRA will recommend to the agencies supervising such dealers that they similarly apply margin requirements.

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[101] Ambassador, Baird, BB&T, BDA, Brean, Clarke, Duncan-Williams, FirstSouthwest, Mischler, Pershing, Shearman, SIFMA and Simmons.

[102] See note 10 supra.

5. Alternatives Considered

FINRA considered a number of alternatives in developing the proposed rule change. As discussed further in Item II.C of this filing, FINRA considered, among other things, alternative formulations with respect to concentration limits, excepting certain product types from the margin requirements, excepting trades with longer settlement cycles from the margin requirements, modifications to the de minimis transfer provisions, modifications to the proposed risk limit determination provisions and establishing exceptions for mortgage brokers from some or all provisions of the proposed rule. For example, FINRA considered establishing an exception from the proposed margin requirements for transactions settling within an extended settlement cycle. However, FINRA has been advised by market participants and other regulators, including the staff of the FRBNY, that such an exception could potentially result in clustering of trades around the specified settlement cycles in an effort to avoid margin expenses. Such a practice would fundamentally undermine FINRA's goal of improving counterparty risk management. Accordingly, as discussed further in Item II.C, FINRA determined to retain the specified settlement cycles in the proposed definition of Covered Agency Transactions as set forth in the Notice and, as an alternative, to establish the $2.5 million per counterparty exception.

FINRA also evaluated various options for the proposed maintenance margin requirement. FINRA analyzed maintenance margin requirements imposed by regulators for other forward settling contracts. These regulators have adopted margin requirements that reflect the risk in these products, while balancing the cost of the margin requirements.

Based on this analysis, as discussed above, FINRA has determined to propose 2% as the appropriate maintenance margin rate, as specified in the proposed rule.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

The proposed rule change was published for comment in Regulatory Notice 14-02 (January 2014) (the "Notice"). Twenty-nine comments were received in response to the Notice. A copy of the Notice is attached as Exhibit 2a. A list of commenters[103] is attached as Exhibit 2b. Copies of the comment letters received in response to the Notice are attached as Exhibit 2c. Detailed discussion of the comments received on the proposed rule change, and FINRA's response, follows below. A number of the comments that speak to the economic impact of the proposed rule change are addressed in Item II.B of this filing.

1. Scope of Products

As proposed in the Notice, the rule change would apply to: (1) TBA transactions,[104] inclusive of ARM transactions, for which the difference between the trade date and contractual settlement date is greater than one business day; (2) Specified Pool Transactions[105] for which the difference between the trade date and contractual settlement date is greater than one business day; and (3) transactions in CMOs,[106] issued in conformity with a program of an Agency or GSE, for which the difference between the

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103 All references to commenters are to the commenters as listed in Exhibit 2b.

104 See note 3 supra.

105 See note 4 supra.

106 See note 5 supra.

trade date and contractual settlement date is greater than three business days.[107] As discussed in the Notice and in Item II.A of this filing, these product types and settlement cycles are congruent with the recommendations of the TMPG.

Commenters expressed concern that the scope of products proposed to be covered by the rule change is overbroad, that the TBA market has not historically posed significant risk and that regulation in this area is not necessary.[108] Commenters suggested that imposing margin requirements on these types of products would have detrimental effects on various market participants, in particular smaller member firms, mortgage bankers, investors and consumers of mortgages, and that these detrimental effects would outweigh the regulatory benefit.[109] Many commenters suggested FINRA should ameliorate the proposal's impact by excluding some of the product types altogether, or by specifying a longer excepted settlement cycle than the proposed one business day with respect to TBA transactions and Specified Pool Transactions and three business days with respect to CMOs.[110] For example, some commenters suggested that by imposing requirements solely on TBA transactions, and eliminating Specified Pool Transactions,

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107 As proposed in the Notice, the products covered by the proposed rule change are defined collectively as "Covered Agency Securities." FINRA has revised this term to read "Covered Agency Transactions," which FINRA believes is clearer and more consistent with the proposal's intent to reach forward settling transactions, as discussed further below.

108 Ambassador, BDA, Coastal, Duncan-Williams, FirstSouthwest, MetLife, Mischler, PIMCO and Vining Sparks.

109 See Items II.B.2(a) through II.B.2(c) of this filing for discussion of the proposal's economic impact on mortgage bankers, broker-dealers and retail customers and consumers.

110 Ambassador, Baird, Baum, BB&T, BDA, Coastal, Crescent, FirstSouthwest, MBA, MetLife, Pershing, PIMCO and SIFMA.

ARMs or CMOs from the proposal, FINRA would be able to address most of the risk that exists in the TBA market overall while at the same time avoid causing undue disruption.[111] Some commenters also recommended that, if FINRA determines to impose margin on the TBA market, then FINRA should specify, for all products covered by the proposal, three or five-day settlement cycles. Commenters suggested that margining for settlement cycles of less than three days would be too burdensome for smaller firms in particular, is unnecessary as it leads to margining of cash settled transactions, and does not truly address forward settling transactions.[112]

As discussed earlier, in response to commenter concerns, FINRA has engaged in extensive discussions with market participants and other supervisors, including staff of the FRBNY. To ameliorate potential burdens on members, FINRA considered, among other things, various options for narrowing the covered product types. The FRBNY staff has advised FINRA that, such modifications to the proposal would result in a mismatch between FINRA standards and the TMPG best practices, thereby resulting in perverse incentives in favor of non-margined products and leading to distortions of trading behavior.

FINRA is proposing, as an alternative approach in response to commenter concerns, to establish an exception from the proposed margin requirements that would apply to any counterparty that has gross open positions[113] in Covered Agency

111 Ambassador, Baum, BDA, Coastal, FirstSouthwest and SIFMA.

112 Baird, BB&T, BDA, FirstSouthwest, ICI, MetLife, PIMCO and SIFMA.

113 The proposal defines "gross open positions" to mean, with respect to Covered Agency Transactions, the amount of the absolute dollar value of all contracts entered into by a counterparty, in all CUSIPs. The amount must be computed net

Transactions amounting to $2.5 million or less in aggregate, if (1) the original contractual settlement for all the counterparty's Covered Agency Transactions is in the month of the trade date for such transactions or in the month succeeding the trade date for such transactions and (2) the counterparty regularly settles its Covered Agency Transactions on a DVP basis or for cash.[114] This exception would not apply to a counterparty that, in its transactions with the member, engages in dollar rolls, as defined in FINRA Rule 6710(z),[115] or round robin trades,[116] or that uses other financing techniques for its Covered Agency Transactions.[117]

Though FINRA shares commenters' concerns regarding the potential effects of margin in the TBA market, FINRA believes that margin is needed because the 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 posing risk to the member extending credit and to the marketplace and potentially imposing, in economic terms,

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of any settled position of the counterparty held at the member and deliverable under one or more of the counterparty's contracts with the member and which the counterparty intends to deliver.

114 See proposed FINRA Rule 4210(e)(2)(H)(ii)c.2. in Exhibit 5.

115 See note 48 supra.

116 The term "round robin" trade is defined in proposed FINRA Rule 4210(e)(2)(H)(i)i. to mean any transaction or transactions resulting in equal and offsetting positions by one customer with two separate dealers for the purpose of eliminating a turnaround delivery obligation by the customer.

117 FINRA believes that the exception would not be appropriate for dollar rolls, round robin trades or trades involving other financing techniques for the specified positions given that these transactions generate the types of exposure that the rule is meant to address.

negative externalities on the financial system in the event of failure. While the volatility in the TBA market seems to respond only slightly to the volatility in the U.S. interest rate environment (proxied by the 10-year U.S. Treasury yield),[118] FINRA notes that price movements in the TBA market over the past five years suggest that the market still has potential for a significant amount of volatility.[119] Accordingly, FINRA believes it would undermine the effectiveness of the proposal to modify the product types to which the proposal would apply or to modify the applicable settlement cycles. However, FINRA does not intend the proposal to unnecessarily burden the normal business activity of market participants, or to otherwise alter market participants' trading decisions. To that end, FINRA believes it is appropriate to establish the specified $2.5 million per counterparty exception. Based on discussions with market participants and analysis of selected data,[120] FINRA believes that this should significantly reduce potential burdens on members by removing from the proposal's scope smaller intermediaries that do not

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118 See Item II.B.3 of this filing.

119 To assess volatility in the TBA market, FINRA looked to several sources of information, including: (i) five-day price changes over the previous five years based on selected Deutsche Bank indices designed to track the TBA market (five days corresponds with the proposed settlement cycle and is consistent with the payment period under Regulation T); (ii) margin requirements for interest rate contracts traded on the Chicago Board of Trade ("CBOT") and cleared at Chicago Mercantile Exchange ("CME"); and (iii) margin requirements for repurchase contracts.

120 Based on analyses of TRACE data, FINRA found that about 30 percent of customer trades over selected periods were in amounts under $2.5 million. These trades amounted to approximately half of one percent of the total dollar volume of activity in the TBA market over the selected periods. See also discussion in Item II.B. of this filing.

pose systemic risk.[121] Further, as discussed earlier, because many such intermediaries deal with smaller counterparties, this will reduce the burdens that would be associated with applying the new margin requirements for Covered Agency Transactions.

2. Maintenance Margin

As proposed in the Notice, for transactions with non-exempt accounts, members would be required to collect mark to market margin and to collect maintenance margin equal to 2% of the market value of the securities.

Commenters expressed concerns about the proposed maintenance margin requirement. Some suggested that imposing a maintenance margin requirement would place FINRA members at a competitive disadvantage because investors, rather than bear these types of disproportionate costs, would prefer to leave the TBA market entirely or would take their business to banks or other entities not subject to the requirement.[122] Commenters suggested that a maintenance margin requirement is unnecessary because the aggregate size of the TBA market makes the products easier to liquidate and defaulted positions easier to replace, that there is no precedent for maintenance margin in the TBA market, and that the proposed requirement is not within the scope of the TMPG's

121 FINRA believes that transactions falling within the proposed $2.5 million per counterparty exception do not pose systemic risk given that, as noted above, such transactions are a small portion of the total dollar volume of activity in the TBA market. However, similar to de minimis transfer amounts as discussed further below, FINRA has revised the proposed rule change to clarify that amounts subject to the exception would count toward a member's concentration limits as set forth under paragraph (e)(2)(I) of the rule as redesignated. See Item II.C.6 of this filing.

122 AIA, Clarke, Credit Suisse, Shearman, SIFMA and SIFMA AMG.

recommendations.[123] Some commenters suggested that maintenance margin would not provide significant protection and that the proposal should establish various tiered approaches, such as thresholds based on transaction amounts or permitting the members to negotiate the margin based on their risk assessments.[124] On the other hand, some commenters suggested they support or at least do not object to maintenance margin at specified percentages of market value or for some of the products.[125]

In response to commenter concerns, FINRA is revising the proposed maintenance margin requirement for non-exempt accounts. Specifically, the member would be required to collect maintenance margin equal to two percent of the contract[126] value of the net long or net short position, by CUSIP, with the counterparty.[127] However, no maintenance margin would be required if the original contractual settlement for the Covered Agency Transaction is in the month of the trade date for such transaction or in the month succeeding the trade date for such transaction and the customer regularly settles its Covered Agency Transactions on a DVP basis or for cash. Similar to the proposed $2.5 million per counterparty exception, the exception from the required maintenance margin would not apply to a non-exempt account that, in its transactions

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[123] AMG, BDA, Clarke, FIF, FirstSouthwest, Sandler and SIFMA.

[124] Baird, BB&T, Clarke, Duncan-Williams, Shearman and Vining Sparks.

[125] MountainView and Pershing.

[126] As proposed in the Notice, the rule would specify "market value." FINRA has replaced "market value" with "contract value" as more in keeping with industry usage.

[127] See the definition of "maintenance margin" under proposed FINRA Rule 4210(e)(2)(H)(i)f. and the treatment of non-exempt accounts pursuant to proposed FINRA Rule 4210(e)(2)(H)(ii)e. in Exhibit 5.

with the member, engages in dollar rolls, as defined in FINRA Rule 6710(z), or round robin trades, or that uses other financing techniques for its Covered Agency Transactions.

The TMPG recommendations do not include maintenance margin. FINRA understands, however, that the TMPG does not oppose the proposed maintenance margin requirements. Commenters opposed maintenance margin because of its impact on non-exempt accounts.[128] However, FINRA believes the proposed two percent amount aligns with the potential risk in this area. FINRA's analysis of selected indices designed to track the TBA market over the past five years identified instances of price differentials of approximately two percent over a five-day period.[129] Further, FINRA notes that two percent aligns with the standard haircut for reverse repo transactions in FNMA, GNMA and FHLMC mortgage pass-through certificates[130] and approximates the amount charged by MBSD. The two percent amount also approximates the initial margin charged by the CME Group for corresponding products.[131] Accordingly, the two percent amount that

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128 FINRA notes that the assertion that maintenance margin in this market is unprecedented is incorrect. Under current Interpretation /05 of Rule 4210(e)(2)(F), maintenance margin of five percent is required for non-exempt counterparties on transactions with delivery dates or contract maturity dates of more than 120 days from trade date.

129 Indeed, the distribution of five-day price differentials is not a "normal" Gaussian Bell curve, but has a "fat tail" especially on the price decline side.

130 FINRA notes reverse repos are a valid point of comparison because a TBA transaction is very similar in effect to a dealer firm repoing out securities to a counterparty for a term that ends at the date a TBA would settle in the future.

131 FINRA's information as to margin requirements for TBA transactions cleared by MBSD and for repurchase transactions for FNMA, GNMA and FHLMC mortgage pass-through certificates is based on discussions the staff has had with market participants. Margin requirements on various interest rate futures contracts cleared by CME Group is available at: <www.cmegroup.com/trading/interest-rates/us-treasury/ultra-t-bond_

FINRA proposes is consistent with other risk measures in this area. FINRA believes that transactions that are similar in economic purpose should receive the same economic treatment in the absence of a sound reason for a difference.

By the same token, in order to tailor the requirement more specifically to the potential risk, and to address commenters' concerns, FINRA believes that it is appropriate to create the exception for transactions where the original contractual settlement is in the month of the trade date for the transaction or in the month succeeding the trade date for the transaction and the customer regularly settles its Covered Agency Transactions DVP or for cash. FINRA believes that transactions that settle DVP or for cash in this timeframe pose less risk, thereby lessening the need for maintenance margin and reducing potential burdens on members. As discussed earlier, FINRA believes that the exception would not be appropriate for counterparties that, in their transactions with the member, engage in dollar rolls, round robin trades or trades involving other financing techniques for the specified positions given that these transactions generate the types of exposure that the rule is meant to address.

3. De Minimis Transfer

As proposed in the Notice, the proposed rule change would provide for a minimum transfer amount of $250,000 (the "de minimis transfer") 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.

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performance_bonds.html> (for Ultra U.S. Treasury Bond contracts) and <http://www. cmegroup.com/trading/interest-rates/us-treasury/30-year-us-treasury-bond_performance_bonds.html> (for U.S. Treasury Bond contracts).

Commenters voiced various concerns about the proposed de minimis transfer provisions. Some commenters said that members should be permitted to set their own thresholds or to negotiate the de minimis transfer amounts with the counterparties with which they deal.[132] Some commenters proposed alternative amounts or suggested tiering the amount.[133] Some commenters argued that the de minimis transfer provisions would operate as a forced capital charge on uncollected deficiencies or mark to market losses below the threshold amount, which would unfairly burden smaller firms in particular when aggregated across accounts.[134] Commenters suggested that capital charges should not be required below the threshold amount, or that the de minimis transfer provisions should be eliminated altogether.[135]

In response, FINRA has revised the de minimis transfer provisions to provide that any deficiency or mark to market loss, as set forth under the proposed rule change, with a single counterparty <u>shall not give rise to any margin requirement, and as such need not be collected or charged to net capital</u>, if the aggregate of such amounts with such counterparty does not exceed $250,000.[136] As explained in the <u>Notice</u>, the de minimis transfer provisions are intended to reduce the potential operational burdens on members. FINRA believes it is not essential to the effectiveness of the proposal to charge the uncollected de minimis transfer amounts to net capital, which should help provide

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[132] AII, Baird, BDA, FIF, Shearman and SIFMA.

[133] Clarke, Crescent, ICI and MountainView.

[134] Clarke, Sandler and SIFMA.

[135] BDA and Sandler.

[136] <u>See</u> proposed FINRA Rule 4210(e)(2)(H)(ii)f.

members flexibility. FINRA believes that, by permitting members to avoid a capital charge that would otherwise be required absent the de minimis transfer provisions, the proposal should help to avoid disproportionate burdens on smaller members, which is consistent with the proposal's intention. However, FINRA believes it is necessary to set a parameter for limiting excessive risk and as such is retaining the proposed $250,000 amount.[137]

4. Risk Limit Determinations

As proposed in the Notice, members that engage in Covered Agency Transactions with any counterparty would be required to make a written determination of a risk limit to be applied to each such counterparty. The risk limit determination would need to be made by a credit risk officer or credit risk committee in accordance with the member's written risk policies and procedures. As proposed in the Notice, the rule change would further establish a new Supplementary Material .05 to Rule 4210, which would provide that members of limited size and resources would be permitted to designate an appropriately registered principal to make the risk limit determinations.

Some commenters said that the proposed provisions regarding risk limit determinations would be burdensome, that members should be permitted flexibility, that the proposal should allow risk limits to be determined across all product lines (and not be limited to Covered Agency Transactions), and that members should be permitted to

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[137] In this regard, FINRA notes that it has revised the proposal's provisions with respect to concentrated exposures to clarify that the de minimis transfer amount, though it would not give rise to any margin requirement, the amount must be included toward the concentration thresholds as set forth under paragraph (e)(2)(I) as redesignated. FINRA believes that this clarification is necessary as a risk control. See Item II.C.6 of this filing.

define risk limits at the investment adviser or manager level rather than the sub-account level.[138] One commenter said that risk limit determinations should be the responsibility of the broker that introduces the account to a carrying firm.[139]

In response, FINRA has revised proposed Supplementary Material .05 to provide that, if a member engages in transactions with advisory clients of a registered investment adviser, the member may elect to make the risk limit determinations at the investment adviser level, except with respect to any account or group of commonly controlled accounts whose assets managed by that investment adviser constitute more than 10 percent of the investment adviser's regulatory assets under management as reported on the investment adviser's most recent Form ADV. The member may base the risk limit determination on consideration of all products involved in the member's business with the counterparty, provided the member makes a daily record of the counterparty's risk limit usage.[140] Further, FINRA is revising the Supplementary Material to apply not only to Covered Agency Transactions, as addressed under paragraph (e)(2)(H) of Rule 4210, but also to paragraph (e)(2)(F) (transactions with exempt accounts involving certain "good faith" securities") and paragraph (e)(2)(G) (transactions with exempt accounts involving highly rated foreign sovereign debt securities and investment grade debt securities). These revisions should provide members flexibility to make the required risk

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138 BB&T, FIF, Duncan-Williams and SIFMA.

139 Pershing.

140 In addition, as revised, the proposed rule change clarifies that the risk limit determination must be made by a designated credit risk officer or credit risk committee. See proposed FINRA Rule 4210(e)(2)(H)(ii)b. and Rule 4210.05 in Exhibit 5.

limit determinations without imposing burdens at the sub-account level and without limiting the risk limit determinations to Covered Agency Transactions.[141] FINRA believes the 10 percent threshold is appropriate given that accounts above that threshold pose a higher magnitude of risk.

Separately, not in response to comment, as noted earlier[142] FINRA has revised the opening sentence of proposed Rule 4210(e)(2)(H)(ii)b. to provide that a member that engages in Covered Agency Transactions with any counterparty shall make a determination in writing of a risk limit for each such counterparty that the member shall enforce. FINRA believes that this is appropriate to clarify that the member must make, and enforce, a written risk limit determination for each counterparty with which the member engages in Covered Agency Transactions. Further, FINRA is adding to Supplementary Material .05 a provision that, for purposes of any risk limit determination pursuant to paragraphs (e)(2)(F) through (H), a member must consider whether the margin required pursuant to the rule is adequate with respect to a particular counterparty account or all its counterparty accounts and, where appropriate, increase such

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141 To clarify the rule's structure, FINRA is revising paragraphs (e)(2)(F) and (e)(2)(G) so that the risk analysis language that appears under current, pre-revision paragraph (e)(2)(H), and which currently by its terms applies to both paragraphs (e)(2)(F) and (e)(2)(G), would be placed in each of those paragraphs and deleted from its current location. Accordingly, FINRA proposes to move to paragraphs (e)(2)(F) and (e)(2)(G): "Members shall maintain a written risk analysis methodology for assessing the amount of credit extended to exempt accounts pursuant to [this paragraph], which shall be made available to FINRA upon request." FINRA proposes to further add to each: "The risk limit determination shall be made by a designated credit risk officer or credit risk committee in accordance with the member's written policies and procedures." FINRA believes this is logical as it makes the risk limit language more congruent with the language proposed for paragraph (e)(2)(H) of the rule.

142 See note 40 supra.

requirements. FINRA believes that this requirement is consistent with the purpose of a risk limit determination to ensure that the member is properly monitoring its risk and that it is logical for a member to increase the required margin where it appears the risk is greater.

5. Determination of Exempt Accounts

As proposed in the Notice, the rule change provides that the determination of whether an account qualifies as an exempt account must be based on the beneficial ownership of the account. The rule change provides that sub-accounts managed by an investment adviser, where the beneficial owner is other than the investment adviser, must be margined individually.

Commenters expressed concern that exempt account determination and margining at the sub-account level would be onerous, especially for managers advising large numbers of clients.[143] In response, FINRA, as discussed above, is revising the proposed rule change so that risk limit determinations may be made at the investment adviser level, subject to specified conditions. FINRA believes that the proposed risk limit determination language, in combination with the proposed $2.5 million per counterparty exception as discussed above, should reduce potential burdens on members. Individual margining of sub-accounts, however, would still be required given that individual margining is required in numerous other settings and is fundamental to sound practice. FINRA notes that, among other things, an investment adviser cannot use one advised client's money and securities to meet the margin obligations of another without that other

143 Baird, BB&T, BDA, Clarke, FIF, Mischler, Sandler, Shearman and SIFMA AMG.

client's consent and that current FINRA Rule 4210(f)(4) sets forth the conditions under which one account's money and securities may be used to margin another's debit.

6. Concentration Limits

Under current (pre-revision) paragraph (e)(2)(H) of Rule 4210, a member must provide written notification to FINRA and is prohibited from entering into any new transactions that could increase credit exposure if net capital deductions, over a five day business period, exceed: (1) for a single account or group of commonly controlled accounts, five percent of the member's tentative net capital; or (2) for all accounts combined, 25 percent of the member's tentative net capital. As proposed in the Notice, the proposed rule change would expressly include Covered Agency Transactions, within the calculus of the five percent and 25 percent thresholds.

Several commenters said that the five percent and 25 percent thresholds are too restrictive, that they would be easily reached in volatile markets, that they would have the effect of reducing market access by smaller firms, and that the limits should be raised.[144]

In response, FINRA notes that the five percent and 25 percent thresholds are not new requirements. The thresholds are currently in use and are designed to address aggregate risk in this area. FINRA believes that the suggestion that the thresholds are easily reached in volatile markets, if anything, confirms that they serve an important purpose in monitoring risk. Accordingly, FINRA proposes to retain the thresholds, with non-substantive edits to further clarify that the provisions are meant to include Covered Agency Transactions. In addition, the proposed rule change would clarify that de minimis transfer amounts must be included toward the concentration thresholds, as well

144 BB&T, BDA, FirstSouthwest, Mischler, Sandler, SIFMA and SIFMA AMG.

as all amounts pursuant to the $2.5 million per counterparty exception as discussed earlier.[145]

7. Central Banks

As proposed in the Notice, the proposed rule change would not apply to Covered Agency Transactions with central banks. As explained in the Notice, 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. One commenter proffered language to expand the proposed exemption for central banks to include sovereign wealth funds.[146] The Federal Home Loan Banks (FHLB) requested exemption from the requirements on grounds of the low counterparty risk that they believe they present.[147] Two commenters suggested that in the interest of clarity the interpretive language in the Notice as to "central banks" should be integrated into the rule text.[148]

In response, as noted earlier[149] FINRA has revised the proposed rule language as to central banks and similar entities to make the rule's scope more clear and to provide members flexibility to manage their risk vis-à-vis such entities. Specifically, proposed Rule 4210(e)(2)(H)(ii)a.1. provides that, with respect to Covered Agency Transactions with any counterparty that is a Federal banking agency, as defined in 12 U.S.C.

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145 See proposed FINRA Rule 4210(e)(2)(I) in Exhibit 5.

146 SIFMA.

147 FHLB.

148 SIFMA and SIFMA AMG.

149 See note 39 supra.

1813(z),[150] central bank, multinational central bank, foreign sovereign, multilateral development bank, or the Bank for International Settlements, a member may elect not to apply the margin requirements specified in paragraph (e)(2)(H) of the rule provided the member makes a written risk limit determination for each such counterparty that the member shall enforce pursuant to paragraph (e)(2)(H)(ii)b. FINRA believes that, in addition to providing members flexibility from the standpoint of managing their risk, the proposal as revised is more clear as to the types of entities that are included within the scope of the election that paragraph (e)(2)(H)(ii)a.1. makes available to members. Specifically, the terms Federal banking agency, central bank, multinational central bank, and foreign sovereign are consistent with usage in the “Volcker Rules” as adopted in January, 2014.[151] As explained in the Notice, the inclusion of multilateral development banks and the Bank for International Settlements is consistent with usage by the Basel Committee on Banking Supervision (“BCBS”) and the Board of the International Organization of Securities Commissioners (“IOSCO”).[152] FINRA does not propose to include sovereign wealth funds, as such entities engage in market activity as commercial participants. Informed by discussions with the FRBNY staff, FINRA does not propose to include other specific entities, other than the Bank for International Settlements on account of its role vis-à-vis central banks, given that FINRA has been advised that doing

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150 See note 38 supra.

151 See OCC, Federal Reserve, FDIC and SEC, 79 FR 5536 (January 31, 2014) (Final Rule: Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds).

152 See BCBS and IOSCO, Margin Requirements for Non-Centrally Cleared Derivatives, September 2013, available at: <http://www.bis.org/publ/bcbs261.pdf>.

so would create perverse incentives for regulatory arbitrage. Further, absent a showing that an entity is expressly backed by the full faith and credit of a sovereign power or powers and is expressly limited by its organizing charter as to any speculative activity in which it may engage, including such an entity within the scope of the election made available under paragraph (e)(2)(H)(ii)a.1. would cut against the overall purpose of the rule amendments.

8. Timing of Margin Collection and Transaction Liquidation

The proposed rule change, with minor revision vis-à-vis the version as set forth in the Notice, provides that, unless FINRA has specifically granted the member additional time, the member would be required to liquidate positions if, with respect to exempt accounts, a mark to market loss is not satisfied within five business days, or, with respect to non-exempt accounts, a deficiency is not satisfied within such period.

Commenters suggested that the proposed five-day timeframe is too short, that the appropriate timeframe is 15 days, as set forth in current Rule 4210(f)(6), that firms may not be able to collect the margin within the specified timeframe, and that firms should be permitted to negotiate the timeframe with their customers.[153] One commenter sought clarification as to whether a member would be required to take a capital charge on deficiencies on the day such deficiencies are cured.[154]

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153 AII, BB&T, BDA, Credit Suisse, Duncan-Williams, ICI, MetLife, Pershing, Sandler, Shearman, SIFMA and SIFMA AMG.

154 SIFMA.

In response, FINRA believes that the five-day period as proposed is appropriate in view of the potential counterparty risk in the TBA market.[155] Accordingly, the proposed requirement is largely as set forth in the Notice, with minor revision as noted earlier to better align the language with corresponding provisions under FINRA Rule 4210(g)(10)(A) in the context of portfolio margining.[156] Further, consistent with longstanding practice under current Rule 4210(f)(6), FINRA notes that the proposed rule makes allowance for FINRA to specifically grant the member additional time.[157] FINRA maintains, and regularly updates, the online Regulatory Extension System for this purpose. With respect to the curing of deficiencies, FINRA notes that the margin rules have consistently been interpreted so that a capital charge, once created, is removed when the deficiency is cured.

9. Miscellaneous Issues

(a) Cleared TBA Market Products

One commenter suggested that the proposed amendments should apply to Covered Agency Transactions cleared through a registered clearing agency.[158] FINRA does not propose to apply the requirements to cleared transactions at this time given that such requirements would appear to duplicate the efforts of the registered clearing agencies and increase burdens on members.

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155 In the interest of clarity, FINRA is revising paragraph (f)(6) of Rule 4210 so as to except paragraph (e)(2)(H) of the rule from the 15-day timeframe set forth in paragraph (f)(6).

156 See notes 52, 53 and 56 supra.

157 See proposed FINRA Rule 4210(e)(2)(H)(ii)d.

158 Brevan.

(b) Introducing and Carrying/Clearing Firms

One commenter sought clarification as to whether introducing firms or carrying/clearing firms would be responsible for calculating, collecting and holding custody of the customer's margin under the proposed amendments.[159] In response, FINRA notes that Rule 4311 permits firms to allocate responsibilities under carrying agreements so that, for instance, an introducing firm could calculate margin and make margin calls, provided, however, that the carrying firm is responsible for the safeguarding of funds and securities for the purposes of SEA Rule 15c3-3.[160]

(c) Margining of Fails

Three commenters sought clarification as to whether members would be required to margin fails to deliver.[161] In response, FINRA notes that currently Rule 4210 does not require the margining of fails to deliver. However, FINRA notes that members need to consider the relevant capital requirements under SEA Rule 15c3-1, in particular the treatment of unsecured receivables under Rule 15c3-1(c)(2)(iv). FINRA does not propose to address fails to deliver as part of the proposed rule change.

(d) Eligible Collateral

Several commenters suggested that FINRA should clarify that the proposal is not specifying what type of collateral a firm should accept and that there should be flexibility for parties to negotiate collateral via the terms of the Master Securities Forward

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159 Sandler.

160 With respect to any customer funds and securities, an introducing firm is subject to the obligation of prompt transmission or delivery.

161 Pershing, Sandler and SIFMA.

Transaction Agreement (MSFTA).[162] Some commenters suggested the proposal should impose limits with respect to types of collateral.[163] In response, FINRA believes that all margin eligible securities, with the appropriate margin requirement, should be permissible as collateral under Rule 4210 to satisfy required margin.

(e) Protection of Customer Margin; Two-Way Margining

One commenter suggested that, in light of the Bankruptcy Court decision concerning TBA products in the Lehman case,[164] FINRA should enhance protection of the margin that customers post by requiring that members hold the margin through tri-party custodial arrangements.[165] One commenter suggested that, as a way to manage the risk of Covered Agency Transactions, FINRA should implement two-way margining that would require members to post the same mark to market margin that would be required of counterparties, and that FINRA should, as part of the rule change, permit the use of tri-party custodial arrangements.[166]

In response, though FINRA is supportive of enhanced customer protection wherever possible, implementation of such requirements at this time could impose substantial additional burdens on members, or otherwise raise issues that are beyond the scope of the proposed rule change. FINRA is considering the issue of tri-party

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162 AII, Clarke, FIF and SIFMA.

163 BB&T and Duncan-Williams.

164 See Memorandum Decision Confirming the Trustee's Determination of Claims Relating to TBA Contracts, In re Lehman Brothers, Inc., Debtor, 462 B.R. 53, 2011 Bankr. LEXIS 4753 (S.D.N.Y. December 8, 2011).

165 Brevan.

166 ICI.

arrangements but does not propose to address it as part of the proposed rule change. Further, FINRA supports the use of two-way margining as a means of managing risk but does not propose to address such a requirement as part of the rule change.

(f) Unrealized Profits; Standbys

The proposed rule change, with minor revision vis-à-vis the version as set forth in the Notice, provides that unrealized profits in one Covered Agency Transaction may offset losses from other Covered Agency Transaction positions in the same counterparty's account and the amount of net unrealized profits may be used to reduce margin requirements. Further, the rule provides that, with respect to standbys, only profits (in-the-money amounts), if any, on long standbys shall be recognized.

One commenter sought clarification as to whether for long standbys only profits, not losses, may be factored into the setoff.[167] In response, FINRA notes that this is correct.

(g) Definition of Exempt Account

One commenter suggested FINRA should revise the definition of "exempt" account under Rule 4210 to include the non-US equivalents of the types of entities set forth under the definition.[168] In response, FINRA notes that the definition of exempt account plays an important role under Rule 4210 and believes that issue is better addressed as part of a future, separate rulemaking effort.

(h) Standardized Pricing

One commenter suggested FINRA should suggest standardized sources for

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167 SIFMA.

168 Shearman.

pricing and a calculation methodology for the TBA market.[169] In response, though FINRA agrees that market transparency is important, FINRA does not propose at this time to suggest or mandate sources for valuation, as this currently is a market function. FINRA notes that the FINRA website makes available extensive TRACE data and other market data for use by the public.[170]

(i) MSFTA

One commenter sought clarification as to whether FINRA would require a member to have an executed MSFTA in place prior to engaging in any Covered Agency Transactions.[171] In response, FINRA does not propose to mandate the use of MSFTAs. FINRA notes, however, that members are obligated under, among other things, the books and records rules to maintain and preserve proper records as to their trading.

(j) Implementation

Commenters suggested implementation periods ranging from six to 24 months for the proposed rule change once adopted.[172] In response, FINRA supports in general the suggestion of an implementation period that permits members adequate time to prepare for the rule change and welcomes further comment on this issue.[173]

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169 BB&T.

170 See for instance bond data available on the FINRA website at: <http://finra-markets.morningstar.com/BondCenter/Default.jsp>.

171 Vining Sparks.

172 AII, BB&T, Credit Suisse, FIF, ICI and Pershing.

173 FINRA understands that firms that are following the TMPG recommendations have been doing so since the recommendations took effect in December 2013.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 45 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

(A) by order approve or disapprove such proposed rule change, or

(B) institute proceedings to determine whether the proposed rule change should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic Comments:

- Use the Commission's Internet comment form (http://www.sec.gov/rules/sro.shtml); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-FINRA-2015-036 on the subject line.

Paper Comments:

- Send paper comments in triplicate to Robert W. Errett, Deputy Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-FINRA-2015-036. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (http://www.sec.gov/rules/sro.shtml). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10 a.m. and 3 p.m. Copies of such filing also will be available for inspection and copying at the principal office of FINRA. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-FINRA-2015-036 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.[174]

Robert W. Errett
Deputy Secretary

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[174] 17 CFR 200.30-3(a)(12).

EXHIBIT 2a

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.

FINRA
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.

Following is the text of the proposed rule change. Proposed new language is underlined; proposed deletions are in brackets.

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4000. FINANCIAL AND OPERATIONAL RULES

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4210. Margin Requirements

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(e) Exceptions to Rule

The foregoing requirements of this Rule are subject to the following exceptions:

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(2) Exempted Securities, Non-equity Securities and Baskets

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(F) Transactions with Exempt Accounts Involving Certain "Good Faith" Securities

Other than Covered Agency Securities as defined in paragraph (e)(2)(H) of this Rule, [O]on any "long" or "short" position resulting from a transaction involving exempted securities, mortgage related securities, or major foreign sovereign debt securities made for or with an "exempt account," no margin need be required and any marked to the market loss on such position need not be collected. However, the amount of any uncollected marked to the market loss shall be deducted in computing the member's net capital as provided in SEA Rule 15c3-1 [and, if applicable, Rule 4110(a),] subject to the limits provided in paragraph (e)(2)([H]I) [below] of this Rule.

(G) Transactions With Exempt Accounts Involving Highly Rated Foreign Sovereign Debt Securities and Investment Grade Debt Securities

On any "long" or "short" position resulting from a transaction made for or with an "exempt account" (other than a position subject to paragraph (e)(2)(F or H) of this Rule), the margin to be maintained on highly rated foreign sovereign debt and investment grade debt securities shall be, in lieu of any greater requirements imposed under this Rule, (i) 0.5 percent of current market value in the case of highly rated foreign sovereign debt securities, and (ii) 3 percent of current market value in the case of all other investment grade debt securities. The member need not collect any such margin, provided the amount equal to the margin required shall be deducted in computing the member's net capital as provided in SEA Rule 15c3-1 and[, if applicable, Rule 4110(a),] subject to the limits provided in paragraph (e)(2)([H]I) [below] of this Rule.

(H) Covered Agency Securities

(i) Definitions

a. For purposes of this Rule, Covered Agency Securities include:

1. To Be Announced ("TBA") transactions, as defined in Rule 6710(u), for which the difference between the trade date and contractual settlement

date is greater than one business day, inclusive of adjustable rate mortgage (ARM) transactions;

2. Specified Pool Transactions, as defined in Rule 6710(x), for which the difference between the trade date and contractual settlement date is greater than one business day;

3. transactions in Collateralized Mortgage Obligations ("CMOs"), as defined in Rule 6710(dd),[1] issued in conformity with a program of an Agency, as defined in Rule 6710(k), or a Government Sponsored Enterprise, as defined in Rule 6710(n), for which the difference between the trade date and contractual settlement date is greater than three business days.

b. A "mortgage banker" is an entity, however organized, that engages in the business of providing real estate financing collateralized by liens on such real estate.

c. A "counterparty" is any person that enters into a Covered Agency Security transaction with a member and

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1 FINRA has filed paragraph (dd) of Rule 6710 for approval by the SEC. See Securities Exchange Act Release No. 70906 (November 20, 2013), 78 FR 70602 (November 26, 2013) (Notice of Filing of Proposed Rule Change; File No. SR-FINRA-2013-046).

includes a "customer" as defined in paragraph (a)(3) of this Rule.

d. "Bilateral transaction" shall mean a transaction that is not cleared through a registered clearing agency.

e. "Standby" means contracts that are put options that trade over-the-counter, with initial and final confirmation procedures similar to those on forward transactions.

(ii) Transactions in Covered Agency Securities

a. All cash and margin transactions in Covered Agency Securities with any counterparty, other than a central bank, are subject to the provisions of paragraph (e)(2)(H) of this Rule.

b. Members that engage in Covered Agency Security transactions with any counterparty shall make a determination in writing of a risk limit to be applied to each such counterparty. The risk limit determination shall be made by a credit risk officer or credit risk committee in accordance with the member's written risk policies and procedures.

c. Transactions cleared through a registered clearing agency, as defined in paragraph (f)(2)(A)(xxviii) of this Rule, and subject to the margin requirements of that clearing agency shall not be subject to the margin requirements specified in paragraph (e)(2)(H) of this Rule.

d. Transactions with Exempt Counterparties: On any long or short position resulting from a bilateral transaction in a Covered Agency Security with a counterparty that is an "exempt account" as defined under paragraph (a)(13) of this Rule, no maintenance margin shall be required. However, such transactions shall be marked to the market daily and the member shall collect any loss resulting from such marking to market (mark to market loss). The amount of any uncollected mark to market loss shall be deducted in computing the member's net capital as provided in SEA Rule 15c3-1. This deduction shall be applied at the close of business following the business day the mark to market loss was created. If such mark to market loss is not satisfied within five business days from the date the loss was created, the member shall promptly take liquidating action, unless FINRA grants the member an extension of time. (See Supplementary Material .03 of this Rule.) Members may treat mortgage bankers that use Covered Agency Securities to hedge their pipeline of mortgage commitments as exempt accounts for purposes of paragraph (e)(2)(H) of this Rule. (See Supplementary Material .02 of this Rule.)

e. Transactions with Non-Exempt Accounts: On any long or short position resulting from a bilateral transaction in a Covered Agency Security with a counterparty that is not an "exempt account" as defined under paragraph (a)(13) of this Rule, maintenance margin equal to 2% of the market value of the securities subject to the transaction shall be required. In addition, the member shall collect any mark to market loss to the counterparty on such position. The deficiency, which is represented by the sum of the amount of any uncollected maintenance margin and uncollected mark to market loss, shall be deducted in computing the member's net capital as provided in SEA Rule 15c3-1 until such time as the deficiency is satisfied. This deduction shall be applied at the close of business following the business day the deficiency was created. If such deficiency is not satisfied within five business days from the date the deficiency was created, the member shall promptly take liquidating action, unless FINRA grants the member an extension of time.

f. Any aforementioned deficiency or mark to market losses with a single counterparty need not be collected if the aggregate amount of such deficiency or mark to market loss does not exceed $250,000 ("the de minimis transfer amount"), provided the member deducts such amount in computing net capital as provided in SEA Rule 15c3-1. The deduction shall be applied at the close of business following the business day the deficiency or mark to market loss was created. The de minimis transfer amount applies to any required maintenance margin and mark to market losses. The full amount of the sum of the required maintenance margin and any mark to market loss must be collected when such sum exceeds the de minimis transfer amount.

g. Unrealized profits in one Covered Agency Security position may offset losses from other Covered Agency Security positions of the same counterparty account and the amount of net unrealized profits may be used to reduce margin requirements. Only profits (in-the-money amounts), if any, on "long" standbys are recognized.

([H]I) Limits on Net Capital Deductions for Exempt Accounts

(i) Members shall maintain a written risk analysis methodology for assessing the amount of credit extended to exempt accounts pursuant to paragraphs (e)(2)(F) and (e)(2)(G) of this Rule which shall be made available to FINRA upon request.

(ii) In the event that the net capital deductions taken by a member as a result of deficiencies or marked to market losses incurred under paragraphs (e)(2)(F) and (e)(2)(G) of this Rule (exclusive of the percentage requirements established thereunder) exceed:

a. [on] for any one account or group of commonly controlled accounts, 5 percent of the member's tentative net capital (as such term is defined in SEA Rule 15c3-1), or

b. [on] for all accounts combined, 25 percent of the member's tentative net capital (as such term is defined in SEA Rule 15c3-1), and,

c. such excess over the member's tentative net capital as calculated in paragraphs (e)(2)(I)(ii)a or b of this Rule continues to exist[s] on the fifth business day after it was incurred,

the member shall give prompt written notice to FINRA and shall not enter into any new transaction(s) subject to the provisions of paragraphs (e)(2)(F), [or] (e)(2)(G) or (e)(2)(H) of this Rule that would result in an increase in the amount of such excess under, as applicable, [subparagraph (ii)] paragraph (e)(2)(I)(ii) of this Rule.

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• • • **Supplementary Material:** --------------

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.02 Monitoring Procedures. For purposes of paragraph (e)(2)(H)(ii)d of this Rule, members shall adopt procedures to monitor the mortgage banker's pipeline of mortgage loan commitments to assess whether the Covered Agency Securities are being used for hedging purposes.

.03 Deficiency. For purposes of paragraph (e)(2)(H) of this Rule, to the extent a deficiency is cured by subsequent market movements prior to the time the margin call must be met, the margin call need not be met and the position need not be liquidated; provided, however, the deduction from net capital shall be applied on the date following the creation of the deficit.

.04 Determination of Exempt Account. For purposes of paragraph (e)(2)(H) of this Rule, the determination of whether an account qualifies as an exempt account shall be made based upon the beneficial ownership of the account. Sub-accounts managed by an investment adviser, whereby the beneficial owner is other than the investment adviser, shall be margined individually.

.05 Risk Limit Determination. For purposes of paragraph (e)(2)(H)(ii)b of this Rule, 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.

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EXHIBIT 2b

Alphabetical List of Written Comments

1. Email from Robert Pachence, Matthew Resch, and Allen Collins, Ambassador Financial Group ("Ambassador") (March 13, 2014)

2. Email from John R. Gidman, Association of Institutional Investors ("AII") (March 27, 2014)

3. Email from Randall B. Saufley, BB&T Securities ("BB&T") (March 27, 2014)

4. Email from Michael Nicholas, Bond Dealers of America ("BDA") (March 28, 2014)

5. Email from Robert M. Fine, Brean Capital, LLC ("Brean") (March 21, 2014)

6. Email from Aron Landy, Brevan Howard Investment Products Limited ("Brevan") (March 27, 2014)

7. Email from Chris Melton, Coastal Securities ("Coastal") (February 24, 2014)

8. Email from Robert H. Huntington, Credit Suisse Securities (USA) LLC ("Credit Suisse") (March 28, 2014)

9. Email from Nick Duren, Crescent Securities Group, Inc. ("Crescent") (March 28, 2014)

10. Email from Duncan F. Williams, Duncan-Williams, Inc. ("Duncan-Williams") (March 28, 2014)

11. Letter from Cindy L. Konich, Federal Home Loan Bank of Indianapolis ("FHLB") (April 7, 2014)

12. Email from Manisha Kimmel, Financial Information Forum ("FIF") (March 28, 2014)

13. Email from Michael Marz, FirstSouthwest Company ("FirstSouthwest") (March 20, 2014)

14. Letter from Marc S. Porter, Joseph Porzio, and Alexandra Mihaescu, G.X. Clarke & Co. ("G.X. Clarke") (March 28, 2014)

15. Email from Dana L. Bjornson, George K. Baum & Company ("Baum") (March 28, 2014)

16. Letter from Dorothy M. Donohue, Investment Company Institute ("ICI") (March 27, 2014)

17. Email from Jason Valentino and Kevin Budd, Metropolitan Life Insurance Company ("MetLife") (March 28, 2014)

18. Email from Doyle L. Holmes, Mischler Financial Group, Inc. ("Mischler") (March 28, 2014)

19. Email from David H. Stevens, Mortgage Bankers Association ("MBA") (March 28, 2014)

20. Email from MountainView Securities, LLC ("MountainView") (March 28, 2014)

21. Email from Thomas F. Guinan, Pershing LLC ("Pershing") (March 27, 2014)

22. Email from Bill De Leon, Pacific Investment Management Company LLC ("PIMCO") (March 28, 2014)

23. Email from Charles M. Weber, Robert W. Baird & Co. Incorporated ("Baird") (March 28, 2014)

24. Email from Christopher S. Hooper, Sandler O'Neill & Partners, L.P. ("Sandler") (March 28, 2014)

25. Email from Russell D. Sacks, Shearman & Sterling LLP ("Shearman") (March 28, 2014)

26. Email from Mary Kay Scucci and Christopher B. Killian, Securities Industry and Financial Markets Association ("SIFMA") (March 28, 2014)

27. Email from Timothy W. Cameron and Matthew J. Nevins, Asset Management Group of the Securities Industry and Financial Markets Association ("SIFMA AMG") (March 28, 2014)

28. Email from Richard Johnson, Harold Thomas and Carolyn R. May, Simmons First Investment Group, Inc. ("Simmons") (March 28, 2014)

29. Email from Allen Riggs, Vining Sparks IBG, LP ("Vining Sparks") (March 28, 2014)

EXHIBIT 2c

March 13, 2014

<u>In response to the request for comments in Regulatory Notice 14-02 regarding amendments to FINRA Rule 4210 and proposed TBA market margin requirements:</u>

In our opinion the proposed MBS transaction margin requirements as set forth in Notice 14-02 and in the proposed amendments to Rule 4210, while well intended, will have extremely negative consequences for markets, investors, consumers in search of home mortgages, and smaller broker dealers such as ourselves.

While understanding the intent of the amendments the risks they present to the MBS market, to market participants, and to the home buyer are far greater than the potential risks presented by book value degradation between trade and settlement dates on yet to settle trades. In over 20 years of experience stretching back to the early 1990s working for smaller brokerage businesses in which mortgage backed securities have been an integral part, the risks outlined as the reasons to subject such transactions to margin requirements have heretofore been little more than possibilities. Certainly history is not always the best guide, however despite tumultuous markets during this period of time the absence of margin requirements has had little if any deleterious effect on the function or integrity of the MBS market or our financial system as a whole. We believe the efficient functioning of the MBS market throughout these times of great financial upheaval does provide sufficient support to allow this segment of the financial marketplace to continue without the proposed added regulations.

These proposed changes are of great concern to us, potentially threatening the existence of the riskless principal model we follow, and possibly the survival of our firm and other similarly structured firms. However we do believe the impact on the system goes far beyond the potential demise of brokerage firms such as ours.

Large institutional investors will always have a large brokerage firm that will provide them with suitable access to the MBS market. However smaller institutional investors with sporadic investment activity are often not afforded the same access by larger brokerage firms, as their volume of business may be minimal. Smaller brokerage firms that will be most greatly affected by the proposed margin requirements are the firms that are motivated to provide smaller investors with access and information and expertise. With fewer smaller firms comes less access for the smaller investors, and fewer motivated market professionals to service them. The proposed rules amendments will effectively eliminate the ability of BDs with minimal net capital requirements to participate in the MBS market in any meaningful manner.

Even if smaller brokerage firms do survive, the proposed risk limitations may have a great impact on their ability to service clients. As risk limits are approached, brokerage firms will be regulatorily required to cut off access to markets. As market access is reduced or eliminated the number of potential market participants is reduced. The fewer available market participants the less liquid the securities. The less liquid the securities the more volatile the markets. If the need for covering margin requirements is triggered it is most likely because markets are struggling to start with. Without the margin requirement and risk limit restraints there is a better chance of stabilizing markets. Using history as a guide, no matter the condition of markets, trades settle anyway. Counterparties honor their commitments. Other than a single trade with Bear Stearns that we learned was never booked in the confusion of their last days, we have never been witness to a transaction in which a counterparty has backed away from an agreed upon trade.

From the perspective of the end investor it is reasonable to believe that given increased recordkeeping requirements along with the potential need for posting collateral prior to settlement fewer investors will have interest in buying mortgage backed securities. Looking at our client base, bankers may have an added incentive to shy away from investing in the MBS markets, quite possibly and understandably being disturbed at having to post collateral to buy securities they want to use as collateral. Not only will fewer MBS market participants potentially lead to a less liquid market but there may also be the unintended consequence of less money available for homebuyers looking for mortgages.

As referenced in the regulatory notice asking whether the rules changes will result in a shift of business to non-FINRA members we believe there is little doubt that the proposed rules changes will create an uneven playing field to the detriment of FINRA members. Why should a client choose to do business with a FINRA member with the associated real burdens of increased recordkeeping and the potential burdens of posting margin collateral when there are other easy to access providers who are not FINRA members and who are not burdened by FINRA rules in this regard? Putting ourselves in the shoes of our clients, most of whom are bankers and versed in weighing risk, we believe many would pay a premium for securities above the price we could secure for them in order to avoid exposure to extra regulatory requirement no matter how much they value our expertise

The riskless principal option itself may also be in peril. The riskless principal model is a valuable one, providing investors with a broker source that, rather than selling bonds from inventory, shops the market for the most appropriate investment option available unencumbered by positions the firm might hold. Low capital requirements are an incentive for firms to follow this model. The higher effective capital requirements of the proposed rules amendment may force riskless principals out of business, or limit what they can offer. Fewer firms following the riskless principal model means fewer options for end investors. We also believe that FINRA is a stronger and more effective organization with more rather than fewer members. A tiered system is already in place with those financial services organizations that are FINRA regulated and those that are not. Possibly a tiered system within FINRA that would exempt riskless principal model brokers from the MBS variation margin requirements and exposure limitations would be worthy of consideration if the rule changes cannot be set aside altogether.

From a firm perspective, despite maintaining capital that far exceeds our required level, there are very real impediments to our viability if these proposals become rule. In a volatile market both the 5% limit per client and the 25% overall limit could be reached easily. While it is understood that the intended purpose of limits is to avoid overwhelming exposure the idea that triggering these limits and reducing market access when clients may need that market access most acutely appears it would create more systemic risk rather than less.

The proposal to require the posting of variation margin based on mark-to-market calculations is also of great concern to us. Operating as a riskless principal we hold no other securities to use as collateral. Most likely if the de minimis level is reached with one of our brokerage counterparties the exposure would be spread out over a number of exempt clients who would not reach their de minimis threshold creating a funds imbalance until settlement day. It is understood that book profits will offset book losses in calculating exposure however much investment is done with cash and there is less potentially offsetting sell side activity. Additionally if markets are sliding rapidly bid to offer spreads often widen, magnifying the loss and reducing the profit side benefit.

To continue along the lines of bid to offer spreads and market value of securities, how will securities be valued? TBA pools are relatively easy to price in a universally accepted manner. CMOs and specified pools are considerably harder to value. This point is brought home to us every time we look to the street for bids for client securities. Certainly the closer to generic a pool gets the easier it is to value. However there are many characteristics that affect the value of a mortgage backed security. Among those characteristics are pool size, median loan size, geographic dispersion, and underlying credit. CMOs with their many different structures are even harder to value. How will these securities be valued? Yes market values are placed on bonds everyday however it is our experience that pricing services can be grossly inaccurate particularly in volatile markets. Even small price differences could mean the difference between having to post collateral or not.

Beyond the potential burden of meeting margin requirements, pricing unsettled bonds daily will require time, dollars and other resources. Recordkeeping requirements will most likely be more burdensome to smaller firms than larger ones. It may sound like prudent action to require the tracking of market values in this way. If there was little cost we would agree. However the burden could be substantial. Is it the proper and prudent way for the brokerage community to expend resources that could be better put to use serving the client? Particularly in an effort to address a potential risk that has not revealed itself in practice despite many market challenges.

To highlight our comments above we believe the proposed changes to the margin requirement rules will result in the following negative effects:

- reduced market access for clients
- reduced market liquidity
- reduced funds available for home mortgages
- shifts resources away from client service functions
- creates uneven playing field to the benefit of non-FINRA firms
- may push responsible firms out of the business
- may push firms to structures that do not fall under the auspices of FINRA

To end our commentary we would like to reference a portion of the Regulatory Notice that was drawn from the TMPG report. "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]" If we are reading this correctly it is referencing the potential problems that may affect the mortgage backed market negatively if it is not subject to margin requirements as are other segments of the financial market. Looking at the great stress that the mortgage backed market has endured during the economic struggles of the recent past, we saw no greater negative impact to liquidity or efficient settlement nor undue dysfunction in the MBS market than any other financial market despite the absence of margin requirements.

Please look at the history and performance and mechanics of the MBS market and see the many negatives that the additional burdens as proposed in the amended Rule 4210 will present to a currently functional and efficient market.

Thank you for providing the opportunity to comment on this important rules change proposal.

Respectfully,

Robert Pachence Co-CEO Matthew Resch Co-CEO Allen Collins CCO

Ambassador Financial Group
Allentown, Pennsylvania

Association of Institutional INVESTORS™

March 27, 2014

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

Subject: Comments of Institutional Investment Advisers on Proposed Amendments to FINRA Rule 4210

Dear Ms. Asquith:

The Association of Institutional INVESTORS (the "Association") appreciates the opportunity to submit the views of its members regarding FINRA's proposed amendments to FINRA Rule 4210 instituting more rigorous counterparty risk mitigation requirements applicable to broker-dealers participating in the TBA market (the "Proposed Amendments"). Such requirements would materially change how our member firms participate in the forward-settling Agency mortgage-backed securities markets ("Agency MBS"). As discussed below, the Proposed Amendments would also have a bearing on the investment activities of the customers of Association members. While we agree with FINRA's goal of mitigating systemic and counterparty risk, we are particularly mindful of the potential unintended consequences that may result from the Proposed Amendments.

The Association of Institutional INVESTORS is an organization of the oldest, largest, and most trusted federally registered investment advisers in the United States. Collectively, the Association's members manage investments for more than 80,000 ERISA pension plans, 401Ks, and mutual funds on behalf of more than 100 million American workers and retirees who rely on our firms to prudently manage participants' retirement savings and investments in part due to the fiduciary duty we owe these organizations and families. We recognize the significance of this role, and our comments are intended to reflect not just the concerns of the Association, but also the interests of the companies, labor unions, municipalities, families, and individuals we serve.

The Association supported the recent Agency MBS margining recommendation of the Treasury Market Practices Group ("TMPG"), which covers the same products and most of the same primary dealers that would be affected by the Proposed Amendments. Last year, the Association's Market Practices Council held dozens of meetings to promote educational awareness of the TMPG's Agency MBS margining initiative. These efforts assisted in furthering industry-wide adoption of Master Securities Forward Transaction Agreements ("MSFTA") by various market participants and the launch of customer outreach programs by client relationship teams at leading buy-side firms.

Our comments regarding the Proposed Amendments focus on the following topics:

1. Maintenance Margin Requirement;
2. Timeframes for the Collection of Margin and Required Liquidations;
3. Further Clarification of Collateral Requirements; and
4. Proposed Development Period and Implementation Period.

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1. Maintenance Margin Requirement

The Association opposes the requirement that 2% maintenance margin be collected from non-exempt accounts.

Under the Proposed Amendments, bilateral transactions in Covered Agency Securities would be marked to market daily and the member firm would be required to collect from its counterparty any mark to market loss on such transactions. In addition, if the counterparty is a non-exempt account, the member firm would be required to collect maintenance margin equal to two percent (2%) of the market value of the securities subject to the transaction. The Association believes that requiring non-exempt accounts to unilaterally deliver maintenance margin will: (i) have an adverse impact on Agency MBS market liquidity and lead to increased mortgage borrowing costs; (ii) expose non-exempt accounts to member firm counterparty risk and increase systemic risk; and (iii) provide incentive for non-exempt accounts to direct Agency MBS trading away from member firms.

The cost associated with requiring margin maintenance will fall disproportionately on non-exempt accounts because member firms are required to collect and not deliver maintenance margin. These costs are significant because they require accounts to pledge assets that otherwise could be used to generate returns for the account's beneficial owners. Moreover, the costs associated with building the legal and operational infrastructure necessary to track and safeguard pledged assets will be significant. As a result, non-exempt accounts will likely decide to exit the Agency MBS market, reduce Agency MBS trading, or shift their business to non-FINRA regulated banks. Fewer market participants will lead to reduced demand and a consolidation among larger institutions, which will result in reduced liquidity in the Agency MBS market. Reduced liquidity in the Agency MBS market (in particular, the TBA market) will cause a meaningful increase in hedging costs for mortgage originators, which may translate to higher borrowing costs for American homebuyers.

By posting maintenance margin, non-exempt accounts incur the risk that they may not be able to recover posted margin should the member firm default. As a result, requiring maintenance margin will expose non-exempt accounts to unsecured counterparty risk. Non-exempt accounts could partially address this risk by seeking member firm consent to deliver the maintenance margin to a segregated custodial account. However, this would introduce added cost primarily born by the non-exempt account. Furthermore, introducing additional counterparty risk into the Agency MBS market by requiring delivery of maintenance margin will have an incongruous impact because it creates, rather than diminishes, counterparty and systemic risk, which is the goal of both the FINRA Proposed Amendment and the TMPG margining recommendations.

Any significant lack of harmonization between the TMPG margining recommendations and the FINRA Proposed Amendments is likely to drive market participants away from member firms and to non-FINRA regulated banks. The TMPG margining recommendations require bilateral variation margining and do not require that member firms collect maintenance margin. Considering the risks, challenges, and costs associated with posting maintenance margin, non-exempt accounts are likely to be driven out of the Agency MBS market or forced to transact with banks operating under the TMPG margining recommendations. The resulting migration would take business away from member firms and consolidate trading with non-FINRA regulated banks. As mentioned above, the resulting market concentration will have an adverse impact on liquidity and could result in higher home financing costs.

2. <u>Timeframes for the Collection of Margin and Required Liquidation</u>

The Association believes that margin transfer timing should be left to the parties as a point of bilateral negotiation.

The Proposed Amendments state that "(t)he full amount of the sum of the required maintenance margin and any mark to market loss must be collected *when such sum* *exceeds the de minimis transfer amount*."[1] (emphasis added) This creates a requirement to effect immediate transfers or at least "same day" transfers of margin with respect to transactions in Covered Agency Securities.

The Association believes the actual timing of margin transfers should be left to the parties as a point of bilateral negotiation. Each market participant has its own internal credit and audit policies. In addition, most buy-side market participants (although not regulated by FINRA) are subject to their own regulatory or capital requirements that address the safety and soundness of their operations. We believe in light of these existing internal and external credit safeguards, the credit department of each party should have more flexibility when determining their delivery periods.

This flexible approach recognizes that each market participant presents their own unique credit profile and their counterparty may have a reasonable basis to afford each party different treatment with respect to this timing issue. Further, a market participant may want to avoid the obligation of same day transfers as a shorter timeframe creates greater operational burdens and for many market participants, still in the process of building collateral systems and infrastructure, the likelihood of failure is increased.

We recognize FINRA has an obvious interest in establishing rules that promote the safety and soundness of the entities subject to its jurisdiction. However, this needs to be balanced against the possible negative impact of such timing requirements on market participants, including those *not regulated* by FINRA. Therefore, the Association proposes that with respect to the required timing of margin, the Final Rule should establish that the maximum period allowed for the collection of margin should be no later than two (2) business days after timely written notice of such requirement to deliver margin.

The Association believes that transaction liquidation action should be at the discretion of the parties based on a number of relevant circumstances.

The Proposed Amendments state that if a "market loss is not satisfied within five business days from the date the loss was created, the member shall promptly take liquidating action, unless FINRA grants the member an extension of time."[2] The Association raises two concerns with the timing of this requirement to liquidate a transaction in Covered Agency Securities.

First, the Association believes that the suggested five day period is arbitrary. In two instances under Rule 4210, there is a five business day period within which certain margin obligations need to be satisfied.[3] However, in those instances the margin is related to transactions or arrangements where there is a direct extension of credit to a client's account. The margin obligations contemplated under the Proposed Amendments result

[1] Proposed §4210(e)(2)(H)(ii)(f)

[2] Proposed §4210(e)(2)(H)(ii)(d) & (e)

[3] *See e.g.* §4210(f)(8)(B)(iii)¶4 (RE: margin requirements for a day trading account) and §4210(f)(8)(B)(iv)d. (RE: special margin accounts for pattern trading account)

from change in market values of the underlying transaction or posted margin and should not be viewed as a direct extension of credit.

The Association makes the further observation that in an analogous situation, SIFMA's[4] "best practice" addressing when a buy-in should occur as the result of a failed delivery of securities on settlement date is *sixty (60) days*. Despite the failure of a seller to perform its delivery obligations, it is recognized that such failure is often the result of a corresponding delivery failure *to the seller* and not related to the creditworthiness of the seller. Notwithstanding that exposure could continue to accrue, the market practice is to extend two months to each party to resolve the failure. We believe these same market participants are able to determine the timing that is reasonable for a liquidation of a transaction caused by a failed margin delivery as the failure could be unrelated to the pledgor's credit but instead related to the pledgor's inability to settle a corresponding trade.

Second, the Association does not believe the Proposed Amendments sufficiently address the existence of good faith disputes with respect to the valuation of the forward settling Covered Agency Security or the value of previously posted margin. The rule should make some accommodation for the parties' ability to engage in such disputes and the Association imagines this could be structured in a way so as to avoid a material increase in counterparty risk (*e.g.* a dispute does not result in liquidation so long as there is a transfer of any undisputed amount).

In volatile markets, when pricing sources are not able to provide recent bid/ask pricing, there is greater likelihood for the parties to dispute the forward exposure created by a Covered Agency Security or the value of any posted margin. In addition, FINRA has provided that all Margin Equity Securities should be eligible collateral. It is anticipated that smaller, fixed income only market participants will have less familiarity with the equity markets and therefore the pricing of such equity securities potentially could also result in disputes.

Therefore, the Association believes the parties to a Covered Security Transaction should have more flexibility in determining what constitutes a technical default under the MFSTA and whether a liquidation or waiver and cure of such default or other workout is in the best interest of the parties. In addition, as the regulatory community is undoubtedly aware, the Association would like to mention that the industry has already begun executing the MFSTA to comply with the TPMG's recommended best practices for margining forward-settling securities. If market participants are required to implement the proposed FINRA requirements regarding required liquidation, it will result in substantial and costly renegotiation of completed MSFTAs.

[4] Through its predecessor, The Bond Market Association

3. Further Clarification

The Association seeks clarification from FINRA concerning certain items that relate to Minimum Transfer Amount and Eligible Collateral.

Minimum Transfer Amount

In the Proposed Amendments, it is stated, "Any aforementioned deficiency or mark to market losses with a single counterparty need not be collected if the aggregate amount of such deficiency or mark to market loss does not exceed $250,000 ("the de minimis transfer amount")…"[5]. The de minimis transfer amount is intended to strike a balance between ensuring a party is sufficiently collateralized given its overall exposure and avoiding small margin transfers that create excessive operational burdens and costs relative to the overall value of margin being transferred.

The Association would seek two clarifications on this point. First, we would ask that FINRA clarify that the de minimis transfer amount applies to *returns* as well as deliveries of collateral. As it is drafted now, the Proposed Amendments require that the de minimis transfer amount only applies to transfer of a "deficiency or mark to market loss" and is silent as to the amount that has to be returned (based upon changes in the mark to market loss) to a counterparty that has previously posted margin.

Second, the Association would ask FINRA to confirm that the parties are free to negotiate a de minimis transfer amount that is *less than* the $250,000 stated in the Proposed Amendments, as an amount that is more conservative than the de minimis transfer amount and, thus, would not frustrate the purposes of the Proposed Amendments.

Eligible Collateral

The Regulatory Notice describing the Proposed Amendments states that "…all margin eligible securities, with the appropriate margin requirement, should be permitted as collateral to satisfy required margin".[6] This would expand the current market convention of posting cash or U.S. Treasuries to include corporate and *equity securities*. Notwithstanding the inclusion of equity securities as eligible collateral in the Regulatory Notice, the Association would ask for clarification that the parties are free to negotiate any subset of eligible collateral that may exclude equities or any other security type.

There are several reasons why a party may wish to exclude equities or other collateral types from the eligible collateral agreed between the parties. First, as described above, smaller, fixed income only market participants may not have the familiarity or

[5] Proposed §4210(e)(2)(H)(ii)(f)
[6] Regulatory Notice 14-02 MARGIN REQUIREMENTS – FINRA Requests Comment on Proposed Amendment to the FINRA Rule 4210 for Transactions in the TBA Market

infrastructure necessary to price equities. As a result, holding equities as collateral creates its own systemic risks for market participants. Moreover, many of the third party pricing sources utilized for fixed income securities do not provide pricing for equity securities. Second, a market participant may be subject to a strict set of investment guidelines that does not allow the account to invest in or take possession of equities or other asset types. This could be the case, for example, with a registered mutual fund (whose investment mandate is set forth in its prospectus and SAI) or state regulated pension (which could be subject to state law enabling statutes).

4. <u>Proposed Development Period and Implementation Period</u>

The Association recommends that FINRA conduct further analysis of the impact of the Proposed Amendments.

The Association respectfully recommends that FINRA (perhaps in cooperation with the TMPG and an ad hoc group of buy and sell-side firms) continue to evaluate how best to harmonize their proposed margining rules with the TMPG's margining recommendation. The work to be conducted during this period (the "Development Period") would focus on achieving FINRA's aim of reducing systemic and counterparty risk while avoiding unintended disruption to the Agency MBS market. Other areas of focus could include whether the transaction netting and margining services of the Mortgage-backed Securities Clearing Corporation could be made available, either directly or indirectly, to institutional investment advisers. We also believe policy makers should consider establishing developmental plateaus (which would include regulatory guidance) to enable the major market participants to ultimately establish an updated Agency MBS trading and transaction processing model that simultaneously provides all participants in the marketplace with the most sophisticated and efficient forms of counterparty risk mitigation. To continue the steady progress toward margining Agency MBS and to avoid the risk of confusing buy-side firm clients while regulation is being deliberated, the Association expects that the TMPG margining recommendation will remain in effect during the proposed Development Period. Based on the evaluation performed during the Development Period, the Association believes that FINRA will develop a fuller understanding of the impact of Agency MBS margining and would be prepared to consider revisions to the Proposed Amendments.

The Association believes that an implementation period of eighteen to twenty-four months is appropriate.

Should FINRA decide to advance the rulemaking process without a Development Period, the Association believes that the Proposed Amendments should have an implementation period of eighteen to twenty-four months following the date of final SEC approval. This timeframe is necessary because each asset management firm will require considerable time to make operational, trading and legal agreement changes needed to comply with the Proposed Amendments. These changes could be extensive depending on the degree of harmonization between the Proposed Amendments and the TMPG's margining recommendation. For example, intense legal negotiations may be required and client outreach will be necessary to educate and seek client approval. Also, implementation will be delayed while firms seek appropriate regulatory input on interpretive matters until best practices ultimately evolve.

In conclusion, the members of our Association have been active participants in the Agency MBS markets on behalf of institutional investors since the inception of pass-through securities. As noted above, our Association has been responsive on substantive and educational matters regarding the recent recommendations of the TMPG to enhance risk mitigation practices with respect to forward-settling MBS transactions. We believe FINRA's Proposed Amendments to Rule 4210 have the potential to build upon the TMPG's recommendations. At the same time, as indicated in these comments, the Association believes that the Proposed Amendments may adversely impact the Agency MBS market. Please feel free to contact Joseph Sack, Staff Adviser to the Association, with any questions regarding this comment letter.
(joesack@sackconsulting.com / 914-648-0088).

On behalf of the Association of Institutional INVESTORS,

John R. Gidman
President

BB&T Securities

March 27, 2014
Martha E. Asquith
Office of the Corporate Secretary
FINRA
1735 K Street NW
Washington, DC 20006-1506

Dear Ms. Asquith:

This letter summarizes our thoughts and concerns in response to FINRA's Request for Comment on Proposed Amendments to FINRA Rule 4210 for Transactions in the TBA Market (Regulatory Notice 14-02). Although we agree that safeguards and controls are appropriate and necessary for the protection of broker/dealers, their clients, and ultimately our industry, we believe some portions of the Proposal are either not necessary, or operationally challenging. We appreciate this opportunity to reply.

After reviewing the Proposal, speaking with other firms, and participating with various industry groups seeking to establish common perspectives, we recognize that this is not a simple matter. Moreover, complexity is magnified by the fact that similar rules and best practices are important not only to FINRA and its Members, but also to groups such as TMPG. This has caused many of the larger firms to seek parity between TMPG and FINRA. For medium to smaller firms, parity may result in more stringent requirements that will be difficult to administer while trying to remain competitive. Because our firm does not fall under TMPG, we have limited our comments only to what FINRA has outlined in its proposal with no attempt to map it to what other bodies may recommend.

Our response follows the outline of topics that FINRA is seeking comment on as provided in the Regulatory Notice:

1. **Market Participants and Consistency with Other Regulatory Regimes:** Retail clients rarely trade in these instruments on a forward settlement basis, and therefore we believe impact will be minimal to them. Impact on mortgage bankers will be material, not only to smaller firms with limited resources available for meeting of margin requirements, but also to larger firms that may become subject to lower margin call thresholds than their broker may currently allow. Our firm already utilizes a practice for the collection of variation margin; however, the proposal calls for a lower unsecured threshold that will negatively affect accounts that will be called for variation margin at a lower threshold than current processes require.

2. **Impact on Market Participants:** If there is an option to do so, we believe there is a risk of market participants shifting business toward non-FINRA members to avoid the margin requirements. This could result in a competitive disadvantage for FINRA members while not improving the risk management landscape. As mentioned above, some participants are relatively small and have limited resources to meet margin requirements.

3. **Non-Exempt Accounts:** It is our view that the proposed maintenance requirement (2%) does not translate into a material amount of additional protection over and above the variation margin. In our opinion, more robust internal controls and risk practices exercised by members should provide a more desirable level of control. In addition, since the focus of many members has been on mortgage bankers, the broader view across all customer types should be expected to require additional analysis for successful implementation of the variation margin component of the proposal.

4. **Mortgage Bankers:** As mentioned, our firm currently enforces variation margin for mortgage banker accounts. However, because the proposed threshold of $250,000 is lower than the thresholds we utilize, the lower requirement will have a direct negative impact on the volume and frequency of transactions, as well as potentially affect the behavior of mortgage originators due to the tie-up of capital for margin purposes. Suggested alternative:

   When variation margin thresholds are ultimately decided, we suggest also considering member responsibility to evaluate counterparties for the purpose of setting and managing risk limits (#7 below). When considered together, we believe consideration should be given toward allowing members to establish tiered thresholds commensurate with counterparty financial strength rather than a "one size fits all" approach. For example, a $250,000 threshold may be appropriate for a counterparty demonstrating modest financial performance; yet, it may unfairly restrict another with substantial capital, equity, positive net earnings, and/or demonstrating steady growth. Addionally, members with sufficient capital may be willing to allow a higher degree of latitude for stronger counterparties. The "one size" threshold doesn't allow flexibility in that regard.

5. **Eligible Collateral:** Our firm accepts cash and US Government and Agency Securities to meet variation margin requirements. Allowing FINRA members to accept all types of marginable securities (including lower investment grade debt securities, equities that may be lower priced or securities with low liquidity) may create additional layers of risk management control as well as more frequent calls for collateral which could lead to more frequent disputes over the value of such collateral. This approach undermines the core values of market soundness and stability. We assume member firms will be allowed to enforce house rules limiting what is defined as acceptable collateral; however, if the rule allows for more volatile, less liquid, and lower priced securities to be used for margin purposes, firms with more prudent internal practices may find themselves in a less competitive position and find it necessary to "race to the bottom". We believe an acceptable collateral list should be short and of highest quality for the maximum protection to these markets.

6. **Close-out Requirements:** We do not believe a 5 day close-out period is adequate for several reasons. For other types of securities, industry standards allow up to 15 days (including allowable extensions) before close-out efforts must be undertaken to remedy a margin deficiency. In addition, SEC Net Capital Rules do not require capital charges to be taken for margin deficiencies. Because we do not believe the securities defined within the Proposal carry a higher degree of risk, we do not agree that they should be treated differently for the purpose of close-out, or for capital charges. Perhaps an alternative would be to commence taking capital charges on uncollected variation margin after the five days has elapsed, while leaving it to the member to decide the appropriate point in time for close-out, consistent with how other securities are treated. Members should also exercise discretion concerning other appropriate

actions which may include trading restrictions while deficiencies are unresolved. That said, fixing an absolute date for forcing termination rather than at the discretion of the non-defaulting party could have unforeseen consequences. The standard SIFMA Master Securities Forward Transaction Agreement provides that the non-defaulting party "may, at its option, declare an Event of Default . . . and . . . cancel and otherwise liquidate and close out all . . . Transactions. . ."

7. **Risk Limit Determination:** The proposal requires member firms to evaluate counterparties for the purpose of establishing and managing appropriate limits. For all market participants with whom our firm trades, risk based limits are assigned and managed on a daily basis. We believe this is prudent, especially considering time exposure arising from extended settlement periods. As mentioned in #4 above, we also believe that this component of the Proposal should allow for more flexibility for members to establish variation margin thresholds for stronger counterparties.

8. **De Minimis Transfer Amount:** Our firm currently collects margin from mortgage banking clients based on mark to market exposure. However, higher dollar levels are utilized when determinging if a margin deposit is required. Thresholds are determined based on financial condition of the counterparty. Therefore, if a lower de minimis level is implemented, we will experience higher impact to customers currently approved for higher thresholds. Specifically, calls will be required at lower dollar amounts, and issued more frequently than today (as mentioned in #4 above). Not only will the higher frequency of calls be disruptive to these clients, it may also present liquidity issues since more of their available funding will be tied up in margin deposits. We and the client will incur higher processing volumes and expenses related to funds movement between parties.

9. **Effective Date:** As is the case with many firms, our firm is dependent upon outside technology vendors for support in developing and implementing regulatory changes of this magnitude. This proposal covers forward trades spanning TBA/MBS markets for participants that are predominantly exempt but may also be non-exempt, and it carries the dual impact of variation and maintenance margin. It is our belief that implementation in less than 18 months will be difficult to achieve since it will not be prudent to commit vendor support or execute corresponding agreements until the final rule requirements have been determined.

10. **Other Concerns and suggestions:**

    a. **Definition of "forward settlement":** Because we do not believe the market related exposure of the securities covered by this Rule Proposal are of a higher risk profile as compared with any other security type, we do not agree with the point at which "forward settlement" is being defined. Industry standard practice for settlement purposes is T+3. We believe that in order for industry standards to be consistently applied, T+3 should be the standard here as well. Therefore, the point at which a margin call is deemed to be deficient should be T+3, plus 2 days to allow time for any additional resolution and to determine if an extendable event has occurred. Between trade date and T+5, we do not believe any trade situation should be considered abnormal, and as stated earlier, capital charges should not be required.

    b. **Investment Advisors:** This portion of the proposal is a bit confusing. First, does the proposed threshold apply to each money manager in the aggregate, or to each sub account under the money manager? Second, since broker dealers do not typically carry detailed account information for the underlying clients of money managers, collection of margin at that level will be extremely difficult for the brokers as well as for Advisors. In addition, there is added complexity by the fact that some of the Advisor's clients may be exempt, and some may be non-exempt. Without involvement on the part of clearing firms and central depositories to facilitate this process, members may find it very difficult to monitor and collect maintenance or variable margin for these accounts. There are two possible outcomes of this, in our opinion, both negative:

1. money managers prohibit their clients from trading in these markets
2. broker dealers prohibit money managers from trading in these markets

We do not see any middle ground with respect to this part of the proposal.

c. **Risk Limits:** The proposal states that members must "make a determination in writing of a risk limit to be applied to each such counterparty". For clarification, we assume this refers to the member's internal policies and procedures governing the process of setting and managing risk limits for their counterparties. If that is correct, we believe the combination of this process, and the establishment of threshold(s) for the purpose of collecting variation margin should allow members to vary the threshold based on their assessment of risk associated with each counterparty. If our assumption is not correct, then we would be unable to adjust margin requirements in a timely manner because we could be potentially in breach of contract.

d. **Monitoring level of trading by mortgage bankers VS loan portfolio:** Our firm does not currently track, nor does it have a way to track precisely how much a mortgage banker needs to hedge at any given time. Adding that as a component of the rule will present a significant administrative challenge for many members. A possible alternative approach would be for members to require a periodic attestation from each mortgage banker's CFO stating that they remain within the levels necessary to hedge loan portfolios. Another approach would be verification from a reliable third party such as mortgage aggregators.

e. **Concentration Exposure (as measured against a member's net capital):** The Proposal suggests certain levels of concentration at which a member must not add to its open positions until the concentration is eliminated. Although we agree that this is a prudent measure, we believe one of those levels could be unnecessarily restrictive (5% for any account, or group of accounts under common control). The aggregate cap of 25% provides control that should allow for a higher percentage at the account or group level. Ten percent would allow for more flexibility at that level while overall levels are kept under control by the higher cap.

f. **Standardization of pricing rules:** When Rule 4210 is finalized, FINRA may want to suggest standardized pricing sources and calculation methodology. Otherwise inconsistencies between firms will result in unnecessary disputes over margin call calculations, along with settlement delays and associated operational costs.

Again, thank you for allowing us the opportunity to comment on this Proposal. Please contact us with any questions about the content of this letter.

Sincerely,

Randall B. Saufley
Managing Director & CFO

BDA Bond Dealers of America

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March 28, 2014

VIA ELECTRONIC MAIL
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 the Bond Dealers of America (BDA), 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 (Notice), proposed amendments to FINRA Rule 4210 for transactions in the TBA Market (Proposed Amendments). BDA is the only Washington, DC-based group representing the interests of middle-market securities dealers and banks focused on the U.S. fixed income markets.

BDA is pleased to have this opportunity to comment on the proposed amendments and encouraged by some of the language contained in FINRA's Notice. As set forth below, however, we believe that the proposed rule will significantly impact market participants, including in particular, middle market dealers; that the requirement to collect maintenance margin is not appropriate or workable in all instances proposed by FINRA; and the multitudes of non-exempt accounts under investment advisors (IAs) bear special consideration. Overall, we are concerned that the rule as currently proposed would negatively affect liquidity in specified pools and unintentionally force a significant portion of business to T+1 settlement, which could be detrimental for reasons we explain later in this letter.

Before discussing the rule proposal, we would like FINRA to take into perspective the balance between reducing risk, and impairing liquidity in a sector of the market principally occupied by end-user customers. When weighing those factors, it makes sense to us for FINRA to consider separating and exempting MBS specified pools, ARM and CMO markets from the actual TBA market at this time**.**

Given the significant impact on market participants and negative effects on liquidity, the risks of addressing MBS specified pool, ARM, and CMO transactions outweigh the benefits. By contrast, 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 pool, ARM, and CMO markets combined. Taken at the 30,000 foot level, if FINRA were to consider eliminating from the requirements of the rule for all MBS specified pool, ARM, and CMO transactions, FINRA would still capture margining of almost 90% of daily exposure without unintended disruption to the MBS specified pool, ARM, and CMO markets, which will affect retail clients and the subaccounts of investment advisors disproportionately. Additionally, many broker-dealers do not transact business (or are not active) in the actual TBA market because their customers do not require it. As per the FINRA TRACE Fact book, the 50 most active firms account for 99.7% of TBA activity. On the other hand, retail customers and IAs acting on behalf of their subaccounts do not generally transact in TBAs but are very active in the MBS specified pool, ARM, and CMO markets and thus would be hit hardest by the proposed rule.

If the proposal for Rule 4210 will stand, we ask FINRA to consider applying variation/maintenance margin to specified pool, ARM and CMO transactions after T+3 or even, T+5. While this admittedly was not part of the TMPG's recommendations, it would enable customers to match settlements with other investments when simultaneously transacting in other products. For example, equities, corporate and municipal bonds typically settle T+3. If a specified pool, ARM or CMO is swapped for one of those security types, whether buying or selling, it seems unfair for the investor to worry about variation and/or maintenance margin when he or she attempts to match settlement dates. In most cases, the proceeds will net to some degree, and there is little to no systemic risk to these types of transactions. In particular, if one sells T+3 to buy specified pools, one is forced into a potential margining situation affecting cash balances and settlements.

Another benefit of moving to T+3 would come from added liquidity in the marketplace. Generally speaking, many customers of all types will move to T+1 to avoid the margin issue. That being the case, dealers will likely need to fund more positions as a result of their market making for customers. Moving to T+3 will allow them the opportunity to find buyers for a few days before having to worry about margining or capital charges in a relatively low risk business.

We encourage these treatments of CMOs, ARMs and specified pools as they will not detract from FINRA's goals of managing risk, and at the same time, providing this relief avoids potential pitfalls of implementation that would harm liquidity. Given the rule as proposed, however, this letter sets forth below additional proposed solutions for your consideration that could help to mitigate negative impacts.

I. Maintenance Margin Requirements

Collection of maintenance margin from non-exempt accounts is misguided and unprecedented in these markets. Under the existing proposal, FINRA would require a member firm to collect maintenance margin equal to 2% of the market value of the securities subject to the transaction. The BDA opposes the requirement to collect the 2% maintenance margin from non-exempt accounts, and does not believe it translates into a measurable amount of additional protection beyond what more robust internal controls and risk practices can provide.

The requirement would deviate from the TMPG's best practice recommendation for the exchange of bilateral variation margin. Moreover, this additional requirement may put the member firms at a disadvantage in the MBS market. Additionally, we believe the bilateral exchange of variation margin fully covers the member firms for the total exposure on Covered Agency Securities transactions and that the 2% maintenance margin would provide unnecessary additional protection for member firms at the expense of impairing liquidity – effects we address throughout this letter.

Not only is the requirement outside of TMPG's best practice recommendation, but it lacks judicial and regulatory precedent. The collection of the 2% margin exposes counterparties to the credit of the FINRA member firm. Yet there is no case law under the Securities Investor Protection Act that speaks to the status of a counterparty's claim for margin posted to a broker-dealer in a TBA transaction. And, from a regulatory precedent standpoint, while mark to market requirements may be consistent with other regulatory regimes, that is not the case with maintenance margin. In other markets, maintenance margin is required because leverage is used for speculating and trading larger quantities than would be possible if purchases had to be paid for in full upon delivery. If the TBA market is defined to include TBAs, specified pools, ARMs and CMOs, that definition will include many transactions by investors who pay in full on settlement date when the securities are delivered. This relates to our general point that T+3 settlement on all Covered Agency Securities would help, as it would match settlements in equities, corporates and municipals.

Additionally, it is unreasonable to request maintenance margin on a fully paid position. If FINRA insists on the collection of maintenance margin, it should consider allowing maintenance margin to be collected solely on sales to non-exempt counterparties, not on purchases from such customers. It seems unfair to purchase a bond from a counterparty and then ask that counterparty to send a broker-dealer margin to hold until that broker-dealer pays them for their bond.

Maintenance margin is inappropriate for Investment Advisor accounts. In most cases, investment advisors (IAs) have a large percentage of non-exempt accounts, which include retail customers. Given the substantial number of non-exempt accounts under IAs, a significant portion of the market would otherwise be affected by the maintenance margin requirement. In addition, given that these can be buy-and-hold transactions, many non-exempt accounts are currently non-marginable as accounts do not have excess funds available for margining (401k, IRA, etc.). Therefore, it would become impossible for IAs to pull money from accounts to even satisfy a variation margin requirement, never mind a maintenance margin requirement. Based on data from one FINRA member firm, which surveyed over 35 IAs with assets under management ranging from $1 billion to $700 billion, IAs can have upwards of 70% non-exempt accounts and often as many as 100%. The majority of these firms don't have the operational capabilities or the legal right to pull funds from customer accounts for margin purposes. As a result, these end-user customers will be forced to make one of the following poor choices: posting the maintenance margin required, taking their business to a non-FINRA-regulated dealer, or exiting the market altogether in favor of potentially riskier securities.

A capital charge should not be required for maintenance margin. FINRA has proposed requiring the collection of maintenance margin for transactions with non-exempt counterparties when the current deficiency exceeds the minimum transfer amount (MTA). Given that maintenance margin has been included in the MTA, a broker-dealer is unable to collect from a customer until the deficiency reaches the negotiated MTA (as much as $250,000). As such, member firms are required to deduct the total deficiency from tentative net capital, even though maintenance margin is not true exposure. A firm should not have to take a capital charge for any maintenance margin due from the customer since it is not a "true exposure" to the market.

Should maintenance margin be required by FINRA, a tiered approach should be considered on maintenance margin for trades under a certain amount. By setting an MTA of $250,000 and mandating a capital charge for maintenance margin in addition to variation margin, FINRA is building in a guaranteed capital charge for every broker-dealer, a particularly painful one for small-to-mid-sized firms doing business with customers who will never be exposed at that MTA level. While the

BDA understands the expected benefits, the negatives that come from collecting maintenance margin along with the resulting capital charges outweigh the benefits, as it is unlikely that all accounts would default at the same time. Both requirements disproportionately impact small and middle-market dealers that provide an important source of liquidity to the market in the first place. The requirement could result in these broker-dealers leaving the market; the capital charges may simply be that significant. That said, the BDA proposes a tiered approach for the purposes of exempting all trades under a market value of $500,000 from the maintenance margin requirement. This would ensure that small and mid-size broker-dealer firms are not shut out of the MBS market due to aggregate uncollectable margin leading to high capital charges and potentially forcing member firms to cease trading under concentration limit restrictions, or exiting the market altogether.

Capital charges and collection of margin should not be required below a predetermined threshold amount. FINRA could consider allowing broker-dealers to make their own credit risk determinations. FINRA could allow each broker-dealer to assign a threshold amount to each counterparty, below which there should be no capital charges required, up to a maximum of $100,000, while leaving the MTA at $250,000. This would allow small-to-mid-sized firms with limited capital to continue participating and competing in the MBS market without giving large firms an advantage in terms of credit picking. This requirement can be incorporated with the existing proposed requirement for firms to make risk limit determinations and negotiated as part of the Master Securities Forward Transaction Agreement (MSFTA), which allows for provisions of threshold amounts and other margin determinations. FINRA has already set a precedent to allow firms to set credit limits under Rule 15c3-5 without requiring capital charges. Given the proper threshold, the BDA believes the same should apply to counterparty limits for Covered Agency Securities.

II. Risk Limit Determinations

FINRA should allow the use of a statement of net asset value for the purposes of determining risk limits for sub-accounts of an Investment Advisor. FINRA has proposed that members engaged in Covered Agency Security transactions with any counterparty must determine a risk limit to be applied to each such counterparty. When making risk limit determinations for sub-accounts, we ask that FINRA confirm that a statement of net asset value would constitute adequate information for purposes of this analysis. Investment advisors have indicated that in many cases, due to legal reasons, they are unable to release net worth information or actual financial statements for their sub-accounts. Additionally, in many cases, retail accounts may not have financial statements to send. If a statement of net asset value would not be sufficient, it would force member firms to treat potential exempt accounts as non-exempt accounts, forcing the collection of maintenance margin and potentially pushing these customers out of the market, or to non-FINRA members, or out of the MBS markets.

III. Transactions with Exempt & Non-Exempt Counterparties

The five-day close-out requirement timeframe is too short and extensions will be needed. Disputes regarding price differentials on less liquid issues may take longer than five days to resolve. The BDA appreciates FINRA potentially granting an extension of time, but would like FINRA to provide guidance on what circumstances might prompt the granting of an extension.

The concentration limits proposed by FINRA should be raised. FINRA's proposal establishes a new reporting obligation with respect to concentrated credit exposures at five percent of the member's tentative net capital, or for all accounts combined, 25% of the member's tentative net capital. The BDA believes the concentration limits proposed by FINRA should be reconsidered and raised. In addition, maintenance margin should be excluded from the calculation of the concentration limit as it is not a true measure of exposure. We believe that these thresholds are unattainable by most individual customers of member firms as limits of $250,000 are too high to be reached by trading activity with most smaller customer accounts, including sub-accounts of investment advisors. This could cause further operational challenges and potentially, unnecessary stoppage of trading, particularly for smaller firms. For example, if a minimum transfer amount of $250,000 is applied to all of a member firm's accounts, the firm could very quickly reach a concentration limit of 25%, simply because maintenance margin is being included in the capital charge. As such, it is possible to have plenty of excess capital along with normal mark to market exposure and still be forced to stop transacting business. We believe these thresholds are even more burdensome given the reality that a firm could get hit with a capital charge on maintenance margin it may not have been able to collect because the negotiated MTA has not been reached. BDA would therefore recommend that FINRA raise each threshold to 10% and 30% respectively, but also create an allowance such that any uncollected maintenance margin below that threshold is free from capital charges, as previously explained. Lastly, the BDA would ask that FINRA clarify the definition of "commonly controlled accounts." We understand FINRA means to base the definition on "beneficial ownership," but this isn't clear from the proposal.

IV. Impact on Market Participants

Middle market and small broker-dealers bear disproportionate impacts, and liquidity will be affected. Given that many investment advisers are not legally or operationally prepared to deal with variation and maintenance margin, many have said they will consider moving to T+1 trading. Assuming they plan to stay in the market, broker-dealers will be forced to carry more inventories either as a result of customer selling or the need to hold inventory for next day delivery to satisfy customer demand; the bottom line is that the proposal creates a need for additional funding on the part of the dealer. This may disproportionately affect small and medium member firms as they may lack the ability to finance MBS positions for T+1 trading. As such, business will flow to the primary dealers and large firms that have access to financing.

More specifically, unlike other products in the fixed income markets, MBS need to be funded with tri-party lending due to the sheer number of pools that make up a position. Most mid-size and small broker dealers can not readily access this market. Yet many of these mid-size and smaller dealers provide much of the liquidity in specified pools, CMOs and ARMs as the larger/primary dealers avoid trading in smaller quantities and concentrate on actual TBAs. If not self-clearing, broker-dealers will need access to financing these positions through their clearing firms, which will come at a premium. This premium will put them at a competitive disadvantage. At a minimum, applying the proposed rule to T+3 settlement and beyond would help.

While FINRA's proposal favors those dealers with access to tri-party lenders, it should be noted that most of those dealers also clear through MBSCC. This participation in the clearing facility may also discourage business with any counterparty that is not a member of the MBSCC, as a dealer would not want to post variation margin on one side of a bilateral transaction without the ability to collect from MBSCC on the other side. Therefore, the rule unintentionally favors non-membership in the clearing facility. That being said, larger broker-dealers may not wish to do business with non-members of the clearing facility, and thus may not do business with certain players, thereby reducing liquidity in this market. Compounding this effect, small and middle market dealers that provide important liquidity may also exit the market due to the challenges of financing T+1 trading, and having less liquidity themselves.

Compliance timelines and costs are significant. An additional problem for middle market dealers is the sheer cost of compliance and the significant lead time required to adapt. Some may build their own systems to comply, and in that regard, FINRA should bear in mind that firms that have not historically participated in margin trading will be essentially starting from scratch to create processes around a margin call scenario that may occur very rarely. At the same time firms will start from scratch to build solutions and retail customers will likely be extremely slow or reluctant to understand and partake in the margining process, making the compliance timeline a necessarily lengthy one.

Other firms will look to third party solutions. While a number of vendors are offering products designed as full or partial solutions, we have seen pricing that is so significantly burdensome that purchase of the systems would make it uneconomic to continue in trading TBAs. One product being offered by a TMPG member has been quoted to a number of our members as $500 per account. It is not unusual for even a small or middle market firm to service as many as 3,000 accounts when considering subaccounts of investment advisors. Therefore, the costs of such systems could be as high as $15 million per year – clearly a game-changing burden for middle-market dealers. Additionally, it should be noted that the option of clearing through MBSCC is out of reach for most middle market dealers due to its cost, and the process to join has proven lengthy while solving only those issues surrounding the posting of margin requirements with other broker dealers. One member observed costs of nearly $400,000 per year, and waited ten months for approval to join.

Mortgage Bankers will be negatively affected. With respect to mortgage bankers, smaller firms will particularly feel the effects due to their limited resources for margin requirements. A $250,000 threshold will have a direct negative impact on the volume and frequency of transactions with mortgage banker accounts, as well as affect the behavior of mortgage originators as capital is tied-up for margin purposes. FINRA should consider permitting broker-dealers to establish thresholds commensurate with counterparty strength rather than a one-size-fits- all approach. Moreover, rather than track how much mortgage bankers hedge at any given time, the proposed rule would be more workable requiring mortgage bankers or third party aggregators to state periodically that they remain within levels necessary to only hedge loan portfolios. Lastly, should these solutions not be viable, FINRA should provide clarity as to what member firms need to do in order to be in compliance with this portion of the rule, especially given that FINRA does not regulate mortgage bankers and member firms are not in a position to demand proof of trading positions.

The retail market will be negatively affected. It is our belief these rules will have a direct and significant impact on retail customers. Again, as a result of the proposed rule, customers are likely to move to T+1 settlement for these transactions. However, they may exit the market altogether in favor of riskier securities. While on the surface this may seem acceptable, the unintended consequences are significant, as we have explained earlier in this letter, and include lost liquidity and a search for yield in less safe products to replace yield lost in a government security or a security issued by a GSE.

While direct retail participation (when defined as $100,000 original face or less) is minimal in TBA transactions, it is substantial in non-TBA mortgage security transactions, with 43% of all trading taking place with par values of under $100,000. With CMOs, the participation is even higher; more than half, (and certainly more if calculations are based upon remaining balance) of the transactions are for original face of less than $100,000.

Additionally, much of this business is done indirectly by retail, meaning the sub-accounts of asset managers, which invest in mortgage securities on behalf of their clients. Those accounts are designated as either exempt (assets over $45mm) or non-exempt (assets under $45mm). FINRA rules make each of those sub accounts the legal counterparty to a transaction and the proposed margin rule requires the dealer to collect maintenance margin from any non-exempt counterparty. This significantly increases the number of market participants, which include retail accounts that would now be subject to maintenance margin.

Although not a technical requirement from FINRA, to the extent a firm executes MSFTAs with retail customers, there will be yet another hurdle: it will be difficult to attain a signed MSFTA with a retail customer who hasn't traditionally signed one in the past. Although this is not an insurmountable task, it is a challenge to explain such agreements to a retail customer that even though they are highly unlikely to break through the de minimis threshold, because they are entering into a forward settling transaction, they may need to have an MSFTA or customer agreement and post margin on trades that had been straightforward in the past. Additionally, the documentation of such conversations in order to meet the recordkeeping demands of the rule will be so voluminous, time consuming and operationally challenging for firms, it is not out of the realm of possibility that firms and retail customers will want to get out of the business of trading CMOs or MBS for good. Compounding this problem is the potential for a firm to annually request updated information from their customers, even at the subaccount level, in order to ensure accurate limits are in place. FINRA should allow a long time horizon for compliance, given these realities.

V. Conclusion

In conclusion, BDA is concerned that FINRA has proposed a sweeping change that will impair liquidity and disproportionately impact middle-market dealers when a proposed rule with appropriate carve-outs for the collection of margin -- and a more appropriate focus on TBAs -- could capture the vast majority of the risk mitigation that FINRA, and the TMPG, contemplate. We look forward to working with you and are available to answer any follow-up questions you may have. Thank you again for the opportunity to submit these comments.

Sincerely,

Michael Nicholas
Chief Executive Officer
Bond Dealers of America

BREAN CAPITAL, LLC

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 sell 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

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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.

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

[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

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[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.

* * *

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

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

CREDIT SUISSE

March 28, 2014

Submitted Via Email to pubcom@finra.org

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

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

Dear Ms. Asquith:

Credit Suisse Securities (USA) LLC ("Credit Suisse") is pleased to offer its comments in response to the request for comment by the Financial Industry Regulatory Authority ("FINRA") on its proposed amendments to FINRA Rule 4210 to establish margin requirements for transactions in the "to-be-announced" ("TBA") market (the "Proposal"). Credit Suisse appreciates FINRA's efforts to bolster responsible practices for all members that participate in the TBA market.

As an active member of the Securities Industry and Financial Markets Association ("SIFMA"), Credit Suisse has participated in drafting SIFMA's comment letter[1] and wishes to express our strong support for the opinions expressed therein. We are submitting this comment letter separately to emphasize certain points that are essential to Credit Suisse's business.

I. Proposal Timeframes and Tolerance for Relatively Small Margin Disputes

Credit Suisse has clients all over the world, presenting certain operational challenges to implementing the Proposal. For clients who do not operate on New York business day hours, it will be difficult (if not impossible) for Credit Suisse to collect margin on a T+1 basis. While Credit Suisse does not oppose taking a capital charge for uncollected margin on the day following the day the margin deficit is created, Credit Suisse believes it is very important to confirm that FINRA members would be permitted under the Proposal to agree to negotiated time periods for the satisfaction of margin calls, provided that those time periods did not exceed the time before liquidating action would be required and provided that any required capital charges are taken. Such flexibility would enable Credit Suisse to meet the Proposal's requirements with respect to varying types of clients based on each client's unique position.

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[1] See Letter from Mary Kay Scucci & Christopher B. Killian, SIFMA, to Marcia E. Asquith, FINRA (Mar. 28, 2014).

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Further, in cases of a bona fide good faith dispute over the amount of margin required or the occurrence of a holiday in the counterparty locale, Credit Suisse believes that FINRA should create a process for automatic extensions of the period before liquidating action is required by at least five business days. FINRA could implement this process by creating new electronic codes for requesting an extension on these grounds, consistent with the existing process for requesting extensions under Regulation T and Exchange Act Rule 15c3-3.

Credit Suisse would also like to express its particular support for SIFMA's recommendation that FINRA members be permitted not to take liquidating action when a margin deficit remains outstanding beyond the liquidation period due to a relatively small bona fide dispute over the amount of margin due, provided that the member continues to take a capital charge for such deficit based on its valuation. Requiring all disputes over margin calls to be resolved and reconciled down to the penny (or even to $250,000) would place a large and unnecessary burden on operations staff at member firms and their counterparties.

II. Flexibility in Managing Risk

Credit Suisse believes that it is important that each firm be allowed to consider its own needs and its client's needs in setting a reasonable threshold below which margin would not be collected. Credit Suisse believes that a specifically mandated de minimis transfer amount is overly prescriptive and does not reflect the process by which firms currently conduct credit analyses for clients. A firm should be able to rely on its entire relationship with a client to set appropriate limits, rather than having to follow a particular limit for transactions in Covered Agency Securities.

III. Implementation Period

Credit Suisse believes that an implementation period of at least eighteen months after approval of the Proposal will be essential. Implementation of the Proposal will require significant legal agreement negotiation and renegotiation with clients, system changes in order to collect maintenance margin and diligence on clients and certain clients' subaccounts.

As a primary dealer, Credit Suisse has been working diligently for nearly eighteen months to implement the agency mortgage-backed-securities margining recommendation in the Treasury Market Practice Group's ("TMPG's") Best Practices for Treasury, Agency Debt and Agency Mortgage-Backed Securities Markets (the "TMPG Margining Recommendation"). In implementing the TMPG Margining Recommendation, Credit Suisse has executed margining agreements with a portion of its clients consistent with the industry average.[2] As with other

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[2] At the end of January 2014, primary dealers had, on average, executed margining agreement with roughly 55% of their counterparties, which covered roughly 75% of the notional amount of their Covered Agency Securities

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primary dealers in the TBA market, while the margining agreements executed so far cover a majority of the notional amount of Credit Suisse's Covered Agency Securities (as defined in the Proposal) transactions, Credit Suisse is still in the process of implementing agreements with a significant number of counterparties. Further, given that existing margining agreements are not necessarily consistent with the Proposal (especially with respect to time periods for margin collection and liquidation, minimum transfer amounts, thresholds and initial margin), Credit Suisse expects it will be obligated to renegotiate a large number of the agreements already in place in order to implement the Proposal. Credit Suisse expects that the negotiation and implementation of margining agreements with the remaining counterparties and the requisite renegotiation with clients with whom agreements are already in place will take at least as long as the previous negotiations and, therefore, that an implementation period of no less than eighteen months is necessary.

One reason why the negotiation process is expected to take at least eighteen months is the information that must be obtained by Credit Suisse from money manager clients with respect to such clients' subaccounts. Credit Suisse expects to use similar documentation to comply with the Proposal as with the TMPG Margining Recommendation. As part of its documentation process, Credit Suisse will require certain account information from money manager clients about their subaccounts in order to conduct sufficient due diligence and review. Given that certain money manager clients have hundreds of subaccounts, Credit Suisse expects the information production burden on the money manager clients to be overwhelming and the negotiation with such clients to take months.

In addition, the Proposal's requirement to collect maintenance margin for non-exempt accounts will require significant changes to Credit Suisse's operational systems and processes.

For all of the above reasons, Credit Suisse believes that an implementation period of at least eighteen months should be allowed to implement the Proposal after approval.

IV. Impact on Smaller Clients

Credit Suisse would also like to express concern that the proposed 2% maintenance margin could cause an unfair burden on smaller clients trading in Covered Agency Securities, causing them to leave the business altogether. This could have an effect on available liquidity in the mortgage market. Credit Suisse believes that FINRA should keep this in mind as it considers the Proposal.

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transactions. See Federal Reserve Bank of New York, "TMPG Meeting Minutes" (Feb. 11, 2014), *available at* http://www.newyorkfed.org/tmpg/february_minutes_2014.pdf. Credit Suisse is happy to provide firm-specific data to the regulators, upon a timely request.

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*   *   *

Credit Suisse appreciates the opportunity to comment on the Proposal. Should you have any questions regarding our comments, please do not hesitate to contact the undersigned at (212) 325-3308.

Sincerely,

Robert H. Huntington
Managing Director

CRESCENT
Securities Group, Inc.

March 28, 2014

Marcia E. Asquith
Office of the Corporate Secretary
FINRA
1735 K. Street, NW
Washington, DC 2006-1506

Re: Regulatory Notice 14-02

Dear Ms. Asquith,

Crescent Securities Group, Inc. (Crescent) welcomes the opportunity to provide comment on FINRA's proposed amendments to Rule 4210 outlined in Regulatory Notice 14-02 concerning transactions in the TBA Market.

It is Crescent's view that the amendments as proposed will put mid and small sized broker/dealers at a competitive disadvantage to large firms when dealing in the TBA market. Requiring firms to post margin and mark-to-market prior to trade settlement will put significant restraints on capital for a small firm such as Crescent, and would most likely prevent us from continuing to participate in this market.

Should such requirements be imposed, Crescent would most likely have no recourse but to go to our end customers for the additional margin. It is questionable whether our end customers would be inclined to provide the additional capital that would be required. We believe they would not, and the end result would be a loss of customers and business for Crescent.

Crescent has always and continues to take our counter-party risk seriously. A failure has the potential to seriously impact our net capital requirements. In over thirteen years of dealing in the TBA market, we have never experienced a failure.

The proposed requirements will certainly have a negative impact on the overall TBA market. The pricing of these assets will most likely increase to provide for the additional capital risk posed to firms. Spreads would also increase. The largest dealers in the marketplace would possess too much pricing power over smaller firms who must watch their capital more closely. None of this makes for a more efficient market.

Crescent appreciates the reasons for the proposed amendments and does support efforts to reduce counterparty risk. It is our opinion that the market would be best served by crafting additional exemptions for transactions in the TBA market. It is unusual to have a TBA trade with a

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Member FINRA/SIPC

settlement date six months out as mentioned in the proposal. In instances such as these, additional margin makes sense. We would encourage FINRA to consider exemptions from the proposed margin requirements for any TBA trades settling more than 30 days from trade date. Additionally, we would recommend the *de minimus* transfer amount be raised to no smaller than $5,000,000 per transaction.

Crescent believes the amendments as currently proposed would have a negative impact on mid and smaller dealers, end customers, and the TBA market overall.

Thank you for the opportunity to comment on this proposal.

Regards,

Nick Duren
President
Crescent Securities Group, Inc.

March 28, 2014

VIA ELECTRONIC MAIL
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:

Thank you for the opportunity to comment on the proposed amendment to FINRA rule 4210 for transactions in the TBA market, including CMO's, ARM's, Specified Pool's and TBAs (noted as "Covered Agency Securities").

Although we understand the rationale for addressing "systemic risk" within the market, we believe the new amendments could prove to be more problematic than the current system. The Treasury Market Practices Group (TMPG) of the Federal Reserve Bank of New York has adopted a set of best practices, and we believe the group does not have a solid appreciation of the drastic implications the amendments could create for small to middle size firms, such as Duncan-Williams, Inc. The TMPG is made up of mostly Primary Dealers or "Too Big to Fail" financial institutions (see attachment 1). TMPG's rules were not designed with middle market dealers in mind. Accordingly, TMPG's rules are an imperfect starting point for FINRA to use as the basis for considering and drafting Rule 4210. As currently drafted, the proposed rule will vastly impair the middle-market dealers in more ways than it will help prevent "systemic risk". We ask that FINRA please review our comments and questions regarding the TRACE FACT book, a summary of the rule, and the implications the rule may have on market participants.

I. Trace FACT Book

It is our understanding that the new requirements have been recommended to prevent "systemic risk". In order to evaluate how the new requirements could reduce "systemic risk" we should first review FINRA's 2013 TRACE FACT book highlighting TBA activity. Please observe Table S17 (attachment 2) of the FINRA FACT book regarding TBAs noting MBS activity of which TBAs accounted for 94% of the total activity. An average of 74 firms report TBA trades on a daily basis. The most active 50 firms reporting TBA trades account for 98.8% of the TBA activity and 99.7% of the total par value. We are convinced that the majority of these 50 firms are the 22 Primary Dealers and other large broker/dealers who specialize in these securities. The "systemic risk" that had the biggest effect on the financial systems can be traced directly to leveraged proprietary trading by the primary dealers and not to the failure to margin TBA trades.

II. Summary of Rule

After reviewing the rule, we have questions and comments regarding its contents and suggested actions.

Variation Margin

The proposed rule change provides that all members would be required to collect variation margin (mark-to-market) for trades in Covered Agency Securities when the exposure exceeds $250,000. We agree with the imposition of variation margin, provided the margin remains in increments of $250,000; therefore, margin calls would exist at $250,000; $500,000; $750,000; etc. We have several questions and comments regarding the collection of collateral, as set forth below:

- If three days prior to settlement date and an open TBA trade increases the variation margin greater than $250,000, does a firm have to call for margin? We feel that the initial variation margin calls should have a grace period of 10 days prior to settlement date.
- If a firm makes a margin call on day one and before the fifth day the market changes, negating the margin balance, is a firm still required to demand or pursue the first call?
- New issue CMO's should be exempt, as they settle once a month and pricing is not available until they settle.
- We also question why maintenance margin would be required on trades less than $10,000,000 of which the bulk of these trades are executed by smaller regional dealers.
- Is a firm's margin collateral that it puts up with a non-exempt account considered to be good capital? Are non-exempt accounts considered control locations?

Credit Risk Committee

The amendment also would require members that trade in Covered Agency Transactions to establish a credit risk committee to set risk limits to be applied to each counterparty (non-FINRA member). Duncan-Williams, Inc. has established such a committee, but this requires quite an extensive review that will take valuable time out of each member's day.

Exempt Counterparties

With regard to transactions with Exempt Counterparties, maintenance margin is not required, but variation margin would be required for trades not settled through a registered clearing agency. If the variation margin is not received within 5 business days from the date of the margin call, the member is required to take liquidating action, unless FINRA grants an extension. How does FINRA plan to grant extensions and what will be the number of employee work hours and costs for a firm to ask for an extension? Currently members are permitted to only take a charge to net capital in lieu of collecting margin from exempt accounts. We question why a firm needs to liquidate a position if it is already haircutting its capital.

Non-exempt Counterparties

Transactions with non-exempt accounts that exceed the hedge necessary to cover the mortgage pipeline will require maintenance margin equal to 2% of the market value, in addition to variation margin. How are we to determine if the mortgage banker has hedged more than his pipeline? If we ask for annual reports, we will only receive these once a year and a banker's position could change the following day. This creates many obstacles that our risk committee will have to spend more time on to overcome. If margin is not received within 5 business days for a trade with a non-exempt counterparty, the member must liquidate the trade and is not able to request for an extension. By establishing a risk limit to each non-exempt counterparty and requiring only variation margin, we would relieve liquidity constraints for the mortgage banker and also balance the competitive scales between members and non-members, thus we are against requiring maintenance margin.

III. Impact on Market Participants

Margin Department

Most smaller fixed income broker/dealers are less likely to have a margin department, as the majority of their accounts are DVP or cash. Margin, operations, and compliance can very well cost more than the total margin exposure. Just the control and movement of collateral can increase costs by $100,000+ per year.

Operations

In addition to operations support, firms will be required to hire additional personnel and purchase a reporting system to mark positions on a daily basis and track market activity. Currently, we know of five systems that are available, and the ones that are completely outsourced cost a minimum of $50,000 a year. Any system that is cheaper requires significant employee work hours from our firm in addition to the costs of the system. Firms will also be responsible for the costs of moving collateral. We believe that between hiring additional employees, training the employees, and implementing

Liquidity Constraints

Liquidity constraints will exist as a result of posting variation margin to a counterparty without the ability to collect when the other side of the trade clears through a registered clearing agency. Non-exempt customers will also face liquidity constraints in posting margin, and not being able to post margin could limit their participation in the TBA market.

Non-FINRA Members

Non-FINRA members (non-FINRA regulated dealer banks) will gain an unfair competitive advantage as they remain exempt from any margin regulations and can trade with counterparties, exempt and non-exempt, without the burden of variation or maintenance margin. This unfair competitive advantage will obviously result in transactions processed away from FINRA member firms.

Mortgage Bankers

It is reasonable to believe that the mortgage bankers' processing costs will increase: cost of margin, movement of collateral, money wires, daily market prices for validation of marks, etc. Due to the increase in the processing costs, it is safe to say that the additional costs will be passed on to the consumer and have a negative impact on housing markets.

Collateral

FINRA states "all margin eligible securities, with the appropriate margin requirement, should be permitted as collateral to satisfy required margin". Given FINRA's apparent concern about market risk, it would be counter-intuitive to permit equity securities to be used as collateral, even at 75%, in these highly volatile markets. Most, if not all, Master Securities Forward Transaction Agreements (MSFTAs) only accept exempt securities or cash as good collateral. The standard MSFTA also states that a party can use collateral to re-hypothecate, pledge, and even enter into REPO transactions. Is FINRA going to allow firms to treat collateral received from a margin call the same way?

IV. Conclusion

Institutional investors will always have a large brokerage firm and Primary Dealers that will provide them with access to the MBS market. The smaller institutional investors and retail accounts do not have access to these dealers, as their volume of business may be minimal, but they rely on the small to mid-sized regional broker/dealers. Smaller brokerage firms that will be the most greatly affected by the proposed margin requirements are the firms that are motivated to provide smaller investors and the retail customers with access to information and expertise. With fewer small to mid-sized broker dealers, smaller institutional investors will have less access to motivated market professionals that are willing and able to service them. The proposed rule amendments will ultimately eliminate the ability of small to mid-sized broker/dealers to participate in the MBS market in any meaningful manner.

In conclusion, we are concerned that FINRA has proposed an amendment that will vastly impair the middle-market dealers in more ways than it will help prevent "systemic risk" at this point. We ask FINRA to reconsider many aspects of the proposal and work with the middle-market firms to gain a better understanding of how we can mitigate risks without forcing many firms out of the TBA market. As suggested by FINRA, a six to twelve month period for implementation is warranted. We look forward to working with you, and thank you again for the opportunity to submit these comments and questions.

Sincerely,

Thanks!

Duncan F. Williams
President
Duncan-Williams, Inc.

FHLBI

FEDERAL HOME LOAN BANK OF INDIANAPOLIS

Building Partnerships. Serving Communities.

April 4, 2014

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

Re: Proposed Amendments to FINRA Rule 4210 for Transactions in the TBA Market

Ms. Asquith:

On behalf of the twelve Federal Home Loan Banks (the "FHLBanks"), we are submitting this letter regarding the recently proposed amendments to FINRA Rule 4210 for forward settling transactions of TBAs, specified pools and CMOs. The FHLBanks recognize the importance of maintaining the integrity and efficiency of these markets and support the efforts of FINRA to safeguard them. However, the FHLBanks do not believe the proposed amendments to Rule 4210 to margin agency mortgage-backed security transactions should apply to the FHLBanks due to their status as government-sponsored enterprises ("GSEs") and the inherent low risk the FHLBanks present to their trading counterparties, combined with their relatively low trading volume of agency mortgage-backed securities and their experience and tested practices and procedures for the management of unsecured credit risk.

The twelve FHLBanks, as GSEs, serve the general public interest by providing readily available, competitively priced funds to approximately 7,000 member financial institutions, thereby enhancing the availability of credit for residential mortgages and community development.

While each FHLBank is independently chartered and managed, the FHLBanks issue consolidated debt obligations for which each individual FHLBank is jointly responsible for the payment of principal and interest. The FHLBanks raise funds in the capital markets at narrow spreads to the U.S. Treasury yield curve, and their consolidated obligations receive the same credit rating as the government bond credit rating of the United States, although the consolidated obligations are not obligations of the United States. The FHLBanks' independent federal regulator is the Federal Housing Finance Agency ("Finance Agency"), which was created by the Housing and Economic Recovery Act of 2008. The Finance Agency's stated mission includes ensuring that the FHLBanks operate in a safe and sound manner so they can continue to serve as a reliable source of liquidity and funding for housing finance and community investment. The Director of the

Finance Agency is a member of the Financial Stability Oversight Council, along with the Chairman of the Board of Governors of the Federal Reserve System.

The FHLBanks are each individually rated AAA by Moody's and at least AA by S&P, maintain strong risk management practices, and do not pose a credit risk to their counterparties during the settlement of mortgage-backed securities. Each FHLBank currently manages counterparty risks daily through a variety of risk management policies, procedures, guidelines, and practices. Similarly, each FHLBank manages security-specific market risks and the overall market risk of their balance sheet through a variety of hedging tools. Each FHLBank also uses a variety of funding strategies based on their balance sheet positions at the time of asset purchases, the attributes of the purchased assets, and current and potential future market conditions.

While the FHLBanks are active participants in the agency mortgage-backed securities market, their trading volume is relatively low when compared to the overall agency mortgage-backed securities market. In addition, while the FHLBanks support FINRA's effort to reduce counterparty risk in the agency mortgage-backed securities market, the FHLBanks do not believe that the margining of mortgage-backed securities transactions is comparable to swap transaction margining. In a swap transaction, the FHLBanks and their counterparties enter into long-term relationships and agree to swap a series of cashflows at futures dates. These agreements rely on the counterparties being of sufficient credit quality to be able to support the transactions. Margining assists in this endeavor, as it is tied to the change in value of the long-term contracts that could be monetized at any point by either party. By contrast, mortgage-backed security transactions share more of the qualities of unsecured Federal funds transactions, which are un-margined, short-term agreements. The FHLBanks participate in the unsecured Fed funds market on a daily basis, and have practices and procedures to manage the counterparty risk that are monitored and reviewed by the Finance Agency on an ongoing basis.

In addition, the proposed margin requirements could possibly increase risk to the FHLB system in the case of a failing counterparty combined with an adverse rate movement. In such an environment, the FHLBanks would be required to post additional collateral to a counterparty that is deteriorating in credit quality, thereby putting additional assets at risk. As demonstrated in the Lehman Brothers and MF Global bankruptcies, this additional collateral may become an unsecured exposure to the insolvent entity, and the right to pursue a claim in an insolvency proceeding does not make counterparties whole, as multi-year delays are normal, claims are not paid on a timely basis, and large legal costs are incurred. Current practices and procedures limit trading with counterparties with deteriorating credit quality and thereby limit risk to assets and avoid bankruptcy proceedings.

In summary, while the FHLBanks support the efforts of FINRA to minimize counterparty risk in the agency mortgage-backed securities markets, the FHLBanks believe that the proposed changes to Rule 4210 to margin agency mortgage-backed security transactions should not apply to the FHLBanks due to the low counterparty risk they present as highly rated and creditworthy GSEs, their relatively low trading volumes of mortgage-backed securities, and their continued experience and tested practices and procedures for the management of unsecured credit risk which are regularly monitored and reviewed by the Finance Agency.

Respectfully yours,

Cindy L. Konich, President-Chief Executive Officer
Federal Home Loan Bank of Indianapolis

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March 28, 2014

Marcia E. Asquith
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Re: Regulatory Notice 14-02 – FINRA Request for Comment on Proposed Amendments to FINRA Rule 4210 for Transactions in the TBA Market

Dear Ms. Asquith,

The Financial Information Forum (FIF)[1] would like to take this opportunity to comment on Regulatory Notice 14-02 – FINRA Request for Comment on Proposed Amendments to FINRA Rule 4210 for Transactions in the TBA Market ("MBS Margining Proposal"). FIF recommends that FINRA consider the following modifications to their MBS Margining Proposal:

- Exempt retail and advisory accounts from MBS Margining Proposal requirements
- Match TMPG recommendations to reduce costs and complexity
  - Eliminate maintenance margining requirement thereby eliminating the need for exempt/non-exempt accounts
  - Eliminate requirement to margin at sub-account level
- Account for current business practices
  - Leverage MSFTA form to the greatest extent possible
  - Address the impact of failed trades on margin requirements
- Phase implementation of rule to initially require margining on dealer activity
  - Leverage MBSD for institutional clients
  - Address institutional client complexities (e.g., grace period)

Each of these recommendations is discussed more fully below.

Exempt Retail and Advisory Accounts from MBS Margining Proposal
In addition to FINRA members, the MBS Margining Proposal will impact every entity that transacts with FINRA members in MBS securities. FIF believes that the costs associated with applying the proposal

[1] FIF (www.fif.com) was formed in 1996 to provide a centralized source of information on the implementation issues that impact the financial technology industry across the order lifecycle. Our participants include trading and back office service bureaus, broker-dealers, market data vendors and exchanges. Through topic-oriented working groups, FIF participants focus on critical issues and productive solutions to technology developments, regulatory initiatives, and other industry changes.

requirements to retail[2] and advisory accounts significantly outweigh the benefits of their inclusion in the rule. FIF believes that retail and advisory accounts represent a small percentage of MBS activity and do not pose the kind of counterparty and systemic risk concerns that the MBS Margining Proposal and Treasury Market Practice Group (TMPG) recommendations are aiming to mitigate. However, introducing the MBS Margining Proposal into these accounts would be a tremendous operational challenge with significant costs given that there are generally no systems currently in place to manage and monitor this functionality for these types of accounts. These types of accounts do not typically utilize margining and would not be eligible for this type of margining based on current agreements. Therefore, existing agreements with retail and advisory clients would also need to be updated to address the new margin requirement. This updating would be time consuming and costly. It is important to note that retail and advisory accounts do not have Master Securities Forward Transaction Agreements (MSFTAs)[3]in place. As the impact on counterparty and systemic risk would be low for retail and advisory accounts, but the costs to implementing the MBS Margin Proposal for those accounts would be high, FIF recommends exempting retail and advisory accounts from the MBS Margining Proposal.

Furthermore, FIF disagrees with the view noted in Regulatory Notice 14-02 that "FINRA believes that there are few retail customers that participate directly in this market". While retail and advisory accounts may represent a small percentage of MBS activity (in terms of dollar amounts), we believe there are a substantial number of retail and advisory customers that participate in the market in order to diversify their portfolios. These customers often make small purchases that would not come close to triggering the de minimum transfer amount of $250,000, though a requirement to impose margin on those accounts would require the creation of systems to monitor those accounts and transfer margin, and the creation of separate accounts and documentation, each of which would be costly, in order for FINRA members to continue retail participation in this market. The cost of creating the new systems and accounts may force some FINRA members to exit the market and not be able to provide their clients access to this market to help diversify their portfolios.

Match TMPG Recommendations

It important to note that while FINRA was "informed by the set of best practices adopted by the" TMPG recommendations, what is being proposed has some significant differences from the TMPG recommendations. For example, the MBS Margining Proposal creates a distinction between exempt and non-exempt accounts and requires maintenance margin to be collected for all non-exempt accounts. The creation of accounts that are required to have maintenance margin and those exempt from maintenance margining will introduce operational costs in setting up a system to determine which accounts qualify for exemption and having to monitor those types of accounts and will require the re-negotiation of all existing MSFTAs that do not require mandatory maintenance margin. The inclusion of mandatory maintenance margin is a significant departure from TMPG recommendations. FIF recommends that FINRA not mandate that maintenance margin be collected on MBS trades and therefore eliminate the need for exempt and non-exempt accounts as described in the proposal.

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[2] For purposes of the exemption, FIF believes that retail accounts would be defined as those accounts that do not meet the Rule 4512(c) definition of "institutional account."

[3] Master Securities Forward Transaction Agreements (MSFTAs) provide a legal framework for agency MBS forward trading and the margining of such transactions and are recognized as the industry standard agreement by the Treasury Market Practices Group. See November 14, 2012 TMPG Press Release, TMPG Recommends Margining of Agency MBS Transactions to Reduce Counterparty and Systemic Risks

Another example of divergence from TMPG recommendations is the requirement to margin at the sub-account level. When investment adviser accounts use third party asset managers, broker-dealers may not have a relationship with the sub-account parties. Margining at the sub-account level diverges from current practice and would impose additional operational burden given the multiple sub-accounts typically associated with an adviser. If FINRA matched TMPG recommendations to margin at the adviser account level this would not be an issue.

The consequence of these differences from the TMPG recommendations is the imposition of significant operational and legal costs while not significantly improving counterparty and systemic risks. In order to avoid these costs with only a small benefit, FIF recommends that the FINRA proposal match TMPG recommendations.

Account for Current Business Practices

Several aspects of the MBS Margining proposal are already addressed in the form MSFTA, which was revised to contemplate the TMPG recommendations and are the market standard agreements for this market. Rather than creating new requirements in the MBS Margining proposal, FIF recommends leveraging MSFTA concepts as follows:

- Eligible collateral is generally specified in the MSFTA and negotiated by the parties. As FINRA states the current market convention is to use cash and Treasuries. Rather than deviating from current market practice, FIF recommends that FINRA match their rule to industry practice and define collateral to include the posting of cash and U.S. Treasuries. This approach simplifies marking collateral to market and reduces the need for maintenance of haircut schedules and additional counterparty negotiations.

- Risk limits are currently defined at the adviser/manager level. As stated earlier, it should not be a requirement to set risk limits at the sub-account level. Rather than defining risk limits in the MBS Margining Proposal, firms should be permitted to set limits in MSFTAs based on an analysis of counterparty risk.

- Close out requirements are generally specified in the MSFTA form based on the facts and circumstances of the bilateral agreement. Rather than defining risk limits in the MBS Margining Proposal, FIF recommends that close-out requirements continue to be part of MSFTAs based on broker dealer and counterparty determinations.

- The identification of a “de minimis transfer amount” below which the member need not collect margin is already a negotiated term of the MSFTA. Rather than defining a de minimis transfer amount in the MBS Margining Proposal, FIF recommends that the de minimis transfer amount be set on a counterparty-by-counterparty basis since the appropriate amount will differ based on the facts and circumstances of the counterparty relationship. Additionally, FIF recommends extending the concept of de minimis transfer amount such that there be no capital charge when collateral is not collected below the de minimis transfer amount. We believe this would be consistent with the intent of permitting a de minimis transfer amount.

Finally, there is no discussion in TMPG recommendations or the FINRA proposal on what happens if a transaction fails. We would expect broker-dealers would continue margining until an item clears since the exposure remains until the transaction settles. The interaction between fails and collateral management should be addressed by this proposal.

Phase Implementation to Initially Focus On Dealer Activity

FIF recommends phasing the implementation of the MBS Margining Proposal to initially focus on dealer activity. While additional work will be required, dealers are better positioned to address margining requirements either as part of their existing Mortgage-Backed Securities Division (MBSD) relationships or through bi-lateral agreements for those securities not covered by MBSD.[4] This approach would give the industry sufficient time to work with MBSD to incorporate institutions into MBSD margining services and address other issues unique to institutional clients. It is our understanding that MBSD would consider additional membership structures including non-guaranteed services for institutions that would like to participate in the margining services of MBSD without becoming full members. Additional time is required for further analysis and development of these concepts including the possibility of institutions to join at the fund manager level rather than at the sub-account level as well as the expansion of coverage to include ARMs and CMOs.

Allowing MBSD to perform the required margining services has a number of operational benefits including allowing the industry to reduce costs by leveraging an existing utility service and benefiting from a common mark-to-market transaction price. If MBSD does not act as the independent third party for pricing, other alternatives would need to be evaluated. It will be critical to have independent third party pricing in order to achieve agreement on the value of a transaction subject to margining.

We understand that FINRA has recently renewed its efforts to consider the costs and benefits of its proposals and we urge FINRA to consider the significant costs associated with developing stand-alone margin functionality including:

- Buy/build operational tools to perform margining/collateral management functionality. Implementation effort would include analysis, development and testing.
- Review of outside custodians to hold collateral
- External counsel review of agreements, standards, etc. (legal fees)
- Increased transactional cost for all the back and forth movement of money
- Possible increased headcount to manage and maintain new processes

Additionally, the impact to the MBS marketplace as a whole should be considered. FIF members believe there is a possibility that this proposal will drive participants out of the market – both existing dealers and clients. The impact would be less liquidity and increased spreads. Also, the current requirement to margin at the sub-account level will adversely impact smaller asset managers if they are buying big blocks and selling them to smaller sub-accounts. These asset managers could find themselves hit by margin calls on the buy-side of the transaction without the ability to issue calls on the other side of the transaction. The net result could be either increased processing costs for investors or participants being forced out of the market.

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[4] MBSD is a division of DTCC and currently acts as the only central clearing counterparty for mortgage backed securities. It is important to note that MBSD does not provide margining services for ARMS or CMOs.

Another area of complexity that requires addressing is the common practice of allowing institutional clients a grace period for collection of call. Further discussion is required to link institutional client grace periods to timing of collection of calls that trigger net capital charges for broker dealers. Grace periods are often viewed as essential to clients outside the U.S. who need sufficient time during their business day to fulfill margin obligations. By focusing initially on dealer activity, the implications of grace periods on collection of call can be addressed.

FIF recommends an implementation period of twelve to eighteen months after which dealer activity be subject to an amended MBS margining proposal. There may be significant operational builds that are required to comply with the rule and many firms may already have their technology budgets for 2014 locked into place. Furthermore, the timeframe for inclusion of institutional activity should take into account a realistic assessment of when MBSD will have expanded access to margining services for participants in the MBS space.

FIF would welcome the opportunity to discuss our recommendations with FINRA. Please do not hesitate to contact me at 312-953-9228 or kimmel@fif.com.

Regards,

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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 the FirstSouthwest Company ("FSC"), 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 (Notice), proposed amendments to FINRA Rule 4210 for transactions in the TBA Market (Proposed Amendments). FirstSouthwest is a middle market investment bank who for over 68 years. FirstSouthwest has dedicated expertise and experience in all areas of the capital markets including sales, trading, underwriting throughout the United States Additionally, FSC has a Correspondent Clearing Services group which provides omnibus and fully disclosed clearing services to FINRA member firms for trade execution, clearing and back office services. Services are provided to approximately 80 correspondent firms.

FSC believes that the proposed rule could significantly impact market participants, in particular, middle market dealers and that the requirement to collect maintenance margin may not be appropriate or workable in all instances as proposed by FINRA; and the multitudes of non-exempt accounts under investment advisors (IAs) bear special consideration. FSC believes FINRA is incorrect in their assumption that few retail customers participate in this market. While it may be true that many customers may not participate in the TBA market, most all specified pools, once allocated, will always end up in retail accounts. Many of our customers are community banks who will buy these for their portfolio and will buy these in advance of the pool being allocated.

FINRA has proposed to include as "Covered Agency Securities" (a) TBA transactions, as defined in FINRA Rule 6710(u), for which the difference between the trade date and the contractual settlement date is greater than one business day (including adjustable rate mortgage ("ARM") transactions), (b) "Specified Pool Transactions," as defined in FINRA Rule 6710(x), for which the difference between the trade date and the contractual settlement date is greater than one business day (such transactions, together with TBAs, "Agency MBS" transactions), and (c) transactions in "Collateralized Mortgage Obligations" ("CMOs"), as defined in FINRA Rule 6710(dd), issued in conformity with a program of an "Agency," as defined in FINRA Rule 6710(k), or a "Government Sponsored Enterprise," as defined in FINRA Rule 6710(n), for which the difference between the trade date and contractual settlement date is greater than three business days. In our opinion if FINRA were to consider eliminating from the requirements of the proposed rule all MBS specified pool, ARM, and CMO transactions, FINRA would still capture margining of almost 90% of daily exposure in MBS securities, without unintended disruption to the MBS specified pool, ARM, and CMO markets, including retail clients and the subaccounts of investment advisors.

Maintenance Margin Requirements:

Under the existing proposal, FINRA would require a member firm to collect maintenance margin equal to 2% of the market value of the securities subject to the transaction. First Southwest is opposed to the requirement to collect the 2% maintenance margin from non-exempt accounts. Not only is the requirement outside of Treasury Market Practice Group's ("TMPG's") best practice recommendation, but it lacks regulatory precedent. In other markets, maintenance margin is required because leverage is used for speculating and trading larger quantities than would be possible if purchases had to be paid for in full upon delivery. In the TBA market as defined to include TBAs, specified pools, ARMs and CMOs, investors pay in full on settlement date when the securities are delivered. At FSC many of the MBS purchases are relatively small, often from community banks, with assets of $25 million or less. It is common that we may sell an entire class or TBA coupon of MBS and have allocations to as many as 30 banks, if all of these banks are required to put up a margin of 2%, the amount would be $100,000.00 on a $5 million trade. While the amount of margin falls below the minimum amount, the aggregate would result in a $3 million capital charge to FSC. ($100,000 x 30 banks).

In the TBA MBS markets, a broker-dealer has less risk exposure to a counterparty that sells one TBA and buys another (*e.g.*, in a "dollar roll" trade) than the broker-dealer would have to a counterparty that had just one side of the transaction. For this reason, we believe that the 2% maintenance margin requirement should be calculated only on the counterparty's net position, calculated as the difference between the aggregate market value of all of the counterparty's buy positions in Covered Agency Securities and the aggregate market value of all of counterparty's sell positions in Covered Agency Securities. Further, in order to collect the required maintenance margin from non-exempt accounts, FINRA members will face the operational burden and costs of having to implement new documentation with customers or renegotiate existing documentation. FINRA members' who have business with investment managers will need to have their sub-account customers, permission to post margin to the FINRA member, creating further costs, reducing liquidity for these account and cause delays in trade approvals.

Under the SEC's Net Capital Rule, broker-dealers are not required to take a capital charge for uncollected margin until five business days after the margin call. Rule 15c3-1(c)(2)(xii). Member firms are not required to take liquidation action for uncollected margin until fifteen days after the margin call (or longer if FINRA provides an extension). Rule 4210(f)(6). FSC does not believe that Covered Agency Securities transactions represent a greater risk than transactions in other, generally more volatile, securities, like equities and high yield bonds. We therefore believe that Covered Agency Securities transactions should be subject to the same timeframes for capital charges and transaction liquidation as transactions in other securities unless it can be demonstrated that there are special circumstances that render Covered Agency Securities transactions more risky. Many clients, even large and sophisticated investment managers, are unable to meet margin calls on the same day they are made. Some clients are located in different time zones, and closed for the day by the time the member firm delivers the margin call. Thus we believe one business day period for the collection of margin is simply unrealistic in many cases. FSC would support proposing the current fifteen-day timeframe from FINRA Rule 4210(f)(6) for bilateral transactions in Covered Agency

Securities, especially since liquidation of such transactions, particularly new issue CMOs and Specified Pool Transactions, might take longer and be more complex than FINRA expects.

Concentrated Exposures:

In the Proposed Amendments would provide that, in the event the net capital deductions taken by a member firm as a result of deficiencies or marked to market losses incurred pursuant to certain good faith securities, highly rated foreign sovereign debt securities, and investment grade debt securities or bilateral transactions in Covered Agency Securities, exceed for any one account or group of commonly controlled accounts, 5% of the member firm's tentative net capital (as defined in Exchange Act Rule 15c3-1) or for all accounts combined, 25% of the member's tentative net capital (as defined in Exchange Act Rule 15c3-1) and such excess continues to exist on the fifth business day after it was incurred, the member firm shall give prompt written notice to FINRA and shall not enter into any new transactions that would result in an increase in the amount of such excess.

FSC believes the concentration limits proposed by FINRA should be reconsidered and raised. We believe that these thresholds are unattainable by most customers of member firms and will cause even further operational challenges and potentially, an unnecessary stoppage of trades, particularly for smaller firms. Supplemental Material .04 says that determination of whether an account qualifies as an exempt account shall be made based on the beneficial owner of the account and subaccounts managed by an investment adviser, where the beneficial owner is other than the investment adviser, shall be margined individually. FSC would like to confirm that this principle applies only where the investment adviser manages multiple subaccounts, and that, where an investment adviser manages a single omnibus account and has agreed that the account may be treated as the account of a single principal, the determination of exempt account status can be made based on the status of the entire account and no information about the underlying beneficial owners needs to be obtained by the member firm

Implementation Period:

FSC believes that an implementation period of at last eighteen months after approval would be appropriate as the Proposed Amendments would require member firms and their clients to make numerous operational and costly changes. Moving to shortened time periods for collection of margin and liquidation would be very disruptive to current practices. Many member firms spent a significant part of the past year negotiating agreements to margin their Covered Agency Securities transactions.

FSC would like to stress that many of the points made in the Proposed Amendments are of serious concern to smaller and middle market member firms. Middle market member firms are not "primary dealers" and have not been subject to the TMPG's Best Practices for Treasury, Agency Debt and Agency Mortgage-Backed Securities Markets (the "TMPG Best Practices"). The comprehensive change proposed will likely impair liquidity and disproportionately impact middle-market dealers in all areas of the Agency Mortgage-Backed Securities Markets. Attempting negotiations with clients concerning margin collection with respect to Covered Agency Transactions will be new to many such firms and the operational costs and time required to implement the Proposed Amendments will be proportionally higher and will potentially result in competitive disadvantages to non-TMPG member firm's business in the Agency Mortgage-Backed Securities Markets.

FSC would also like to note on behalf of the member firms we provide clearing services to that theses, smaller firms are an important segment of the market in Covered Agency Securities, especially as regards retail investor participation in the CMO market and services to smaller banks and buy-side investment management firms. FSC respectfully requests that FINRA consider the acute effects of the Proposed Amendments on the smaller member firms.

We look forward to working with you and are available to answer any follow-up questions you may have. Thank you again for the opportunity to submit these comments.

Sincerely,

Michael J. Marz

Michael Marz
Vice Chairman

G.X. Clarke & Co.
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UNITED STATES TREASURY
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March 28, 2014

Submitted Via Email to pubcom@finra.org

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

Re: Comments on Proposed Amendments to FINRA Rule 4210

Dear Ms. Asquith:

G.X. Clarke & Co. (GXCO, the Company) is submitting this comment letter in response to the Financial Industry Regulatory Authority's (FINRA) Regulatory Notice 14-02 (Notice) and proposed amendments to FINRA Rule 4210 for transactions in the Covered Agency Securities and TBA Market.

G.X. Clarke & Co. is a registered broker-dealer in US Government and Agency securities under the Government Securities Act of 1986 (Rule 402.2). GXCO files a Form G-405 "Report on Finances and Operations of Government Securities Brokers and Dealers."

The Company's trading activities consist primarily of securities trading in connection with U.S. Treasury, U.S. Government agency, and agency mortgage-backed obligations, which consist mainly of mortgage-backed "to be announced" (TBA) securities. The Company only deals with regulated institutional customers.

With regulatory capital of $58.250 million at December 31, 2013 ($50.0MM partnership equity and $8.250MM subordinated liabilities) we believe our comments and issues on proposed changes to Rule 4210 will be insightful in highlighting the major impact the change will have on small member firms such as G.X. Clarke & Co.

G.X. Clarke & Co. participated in the BDA and SIFMA working groups in their response to these proposed Rule 4210 changes. However, we feel it is important to highlight the items that explicitly affect our Company.

The following letter summarizes our thoughts and concerns in response to the proposed amendments to FINRA Rule 4210 for Transactions in the TBA Market (Regulatory Notice 14-02). We agree that safeguards and controls are necessary for the protection of broker/dealers, their clients, and ultimately our industry.

We appreciate this opportunity to reply.

1. **Maintenance Margin Requirement:**

   Under the existing proposal, FINRA would require a member firm to collect maintenance margin equal to 2% of the **market value** of the securities subject to the transaction.

   G.X. Clarke & Co. opposes the requirement to collect the 2% maintenance margin from non-exempt accounts. The Company does not believe it translates into a measurable amount of additional protection beyond the variation margin requirement as well as what more robust internal controls and risk practices can provide.

   Additionally, this portion of the proposal is a departure from the recommendations of the TMPG and will be operationally challenging for all market participants, especially investment advisors with thousands of sub-accounts. Based on a survey of over 35 investment advisor customers with assets under management ranging from $1 bn to $700 bn, we've realized a majority of the sub-accounts will fall under non-exempt status. That being the case, many of our investment advisor customers have indicated that due to high costs and drain on resources, they would consider either exiting the market or moving to T+1 trading, which as explained later in this letter, would result in lost liquidity in the MBS markets.

   However, should the FINRA proposal stand, the Company presents the following recommendation as a workable solution to the rule change:

   - **Recommendation** – G.X.Clarke & Co. would like to recommend a tiered approach to applying maintenance margin based on the "net" of open buys and sells with a non-exempt counterparty, as follows:
     - Net buy / sell of $500,000 or less in market value ($10,000 maximum margin) would be excluded
     - Net buy / sell greater than $500,000 in market value would require collection of 2% maintenance margin.

2. **Capital Charges:**

   The $250,000 minimum transfer amount (MTA) poses particular challenges to G.X. Clarke & Co. and other medium and small firms. We view the $250,000 MTA as a "forced" capital charge to all firms. As $250k MTAs would be applied to each account, margin would be uncollectible the majority of the time, which may have the potential to restrict business, especially when aggregated across the sub-accounts of investment advisors, and includes maintenance margin, which is not even true exposure.

While the Rule allows the MTA to be negotiated to a lower amount, this may turn out to be anti-competitive. A firm would not likely agree to a lower MTA with GXCO when they can trade at a higher MTA somewhere else in order to engage in fewer transfers of margin.

- **Recommendation** – G.X.Clarke & Co. would like to recommend a tiered approach to applying Capital Charges on MTA exposure under the $250k maximum:
  - Total deficiency of less than $100,000 would be excluded or 5% capital charge consistent with current Rule 402.2.
  - Total deficiency between $100,000 and $250,000; 10% capital charge.

G.X. Clarke & Co.'s basis for recommending the above changes to this proposal is focused around the "counterparty exposure haircut" included in FOG Rule 402.2. The rule calls this exposure a haircut due to its place in the calculation. In 15c3-1 most exposure charges are treated as a capital charge.

- "The total "counterparty exposure haircut" equals the sum of the counterparty exposure haircuts taken for all counterparties except a Federal Reserve Bank, of the government securities broker or dealer. The "counterparty exposure haircut" equals the product of a counterparty exposure haircut factor of 5 percent and the net credit exposure to a single counterparty not in excess of 15 percent of the government securities broker's or dealer's liquid capital.
  - For GXCO the majority of its counterparty exposure comprises deficits on open trades and exposure on tri-party repo margin.

3. **Documentation: FINRA should allow the use of a statement of net asset value for the purposes of determining risk limits for sub-accounts of an Investment Advisor.**

One of the definitions of an "exempt account" per FINRA Rule 4210(a)(13) is as follows:

- makes available to the member such current information regarding such person's ownership, business, operations and financial condition (including such person's current audited statement of financial condition, statement of income and statement of changes in stockholder's equity or comparable financial reports), as reasonably believed by the member to be accurate, sufficient for the purposes of performing a risk analysis in respect of such person.

Investment advisors have indicated that in many cases, due to legal reasons, they are unable to release net worth information or actual financial statements for their sub-accounts. If a statement of net asset value would not be sufficient, it would force member firms to treat potential exempt accounts as non-exempt accounts, forcing the collection of maintenance margin and potentially pushing these customers out of the market, while at the same time increasing capital charges for the member firm.

- **Recommendation** – G.X.Clarke & Co. would like to recommend a statement of net asset value plus W-9 (will show legal standing) as sufficient information to validate the sub-account and set risk limits. The requirement is to obtain sufficient information in order to qualify a client as an exempt account and set risk limits, which does not necessarily have to include the client's financial statements.

4. **Eligible Collateral:** G.X. Clarke & Co. believes that the collateral eligible for margin should be negotiated between the parties in their MSFTA agreement, or otherwise, as an MSFTA is not required. This issue should not be determined by regulation. Case in point, as a government broker-dealer, GXCO is only permitted to transact in US Government and Agency securities.

5. **Effective Date:** G.X. Clarke & Co. agrees and supports both SIFMA and BDA that an implementation period of eighteen months after approval would be appropriate. The vast majority of our accounts are not prepared for margining. All the complexities from legal, compliance, and IT will take at least that amount of time.

6. **Unintended Consequences - Middle market and small broker-dealers will be most affected and will bear disproportionate impacts in funding, liquidity, trading, and costs.**

   Funding and Liquidity - Given that many investment advisers are not legally or operationally prepared to deal with variation and maintenance margin, many have said they will consider moving to T+1 trading. This may disproportionately affect small and medium member firms as they may lack the ability to finance MBS positions for T+1 trading. As such, business may flow to the primary dealers and firms that have access to financing. Assuming they plan to stay in the market, smaller broker-dealers will be forced to carry more inventories either as a result of customer selling or the need to hold inventory for next day delivery to satisfy customer demand. This creates the need for additional funding on the part of the dealer burdening the small and mid-size broker-dealers disproportionately.

   Unlike other products in the fixed income markets, MBS need to be funded with tri-party lending due to the sheer number of pools that make up a position. Most mid-size and small broker dealers can not readily access this market. Yet many of these mid-size and smaller dealers provide much of the liquidity in specified pools, CMOs and ARMs. The larger/primary dealers avoid trading in smaller quantities and concentrate on actual TBAs.

If not self-clearing with access to tri-party funding, these smaller broker-dealers will need access to financing these positions through their clearing firms, which will come at a premium. This additional cost will put them at a competitive disadvantage.

- **Recommendation** – G.X. Clarke & Co. proposes, at a minimum, T+3 settlements for all MBS Agency products, except TBAs. Small and medium-sized broker-dealers currently use delayed settlement to find liquidity. Should many customers move to T+1, these broker-dealers may need to exit the market. T+3 will provide better liquidity in the MBS market.

Trading - While FINRA's proposal favors those dealers with access to tri-party lenders, it should be noted that most of those dealers also clear through MBSCC. This participation in the clearing facility may also discourage business with any counterparty that is not a member of the MBSCC, as a dealer would not want to post variation margin on one side of a bilateral transaction without the ability to collect from MBSCC on the other side. Therefore, the rule unintentionally favors non-membership in the clearing facility. That being the case, larger broker-dealers may not wish to do business with non-members in the clearing facility. Should that happen, small and middle market dealers that provide important liquidity to end users may exit the market due to the challenges of lost liquidity from the larger dealers

Cost - An additional problem for middle market dealers is the sheer cost of compliance. Some may build their own systems to comply, but others will look to third party solutions. While a number of vendors are offering products designed as full or partial solutions, we have seen pricing that is so significantly burdensome that purchase of the systems would make it uneconomic to continue trading in the TBA markets as defined.

One product being offered by a TMPG member has been quoted to a number of broker-dealers as $500 per account, per month. It is not unusual for even a small or middle market firm to service as many as 3,000 accounts when considering the subaccounts of investment advisors. Therefore, the costs of such systems could be as high as $15 million per year – clearly a game-changing burden for small and middle-market dealers.

- At G.X. Clarke & Co. the cost will be significant. It will, at a minimum, require the addition of 1 to 2 full-time employees to a current department staffed with 5 employees. The Company will be required to add resources for margin and cover additional documentation requirements within the credit department.

- Additionally, technology resources will be required to build and support additional margin system requirements.

7. **G.X. Clarke & Co – Regulatory Capital - FOG.**

G.X. Clarke & Co. is a registered broker-dealer under the Government Securities Act of 1986 and files under Form G-405 "Report on Finances and Operations of Government Securities Brokers and Dealers" per 402.2 (Re: FOG).

With these proposed rules the possibility of duplicative capital charges may occur due to an overlapping of rules. Per the rule, the Company currently calculates capital requirements for registered government securities brokers and dealers and takes a 5% charge on counterparty exposure. This haircut charge was summarized in Section 3.

G.X. Clarke & Co. will need interpretative support from FINRA to ensure that these proposed rules do not duplicate capital charges or haircuts due to an overlapping of rules. This may result in an anti-completive situation if the Company is forced to take higher charges than a broker-dealer subject to Rule 15c3-1.

Summary – G. X. Clarke & Co., as a small institutional broker-dealer, is concerned that these sweeping changes will impair liquidity and disproportionately impact small and medium size firms.

G.X. Clarke & Co. attends various FINRA and industry association conferences. We have heard many times from FINRA representatives that the ultimate goal is for rules to be "fair and equitable to ALL firms". We believe the rules as currently proposed do not achieve this goal.

Thank you for allowing us the opportunity to comment on this proposal. Please feel free to contact us with any questions about the content of this letter.

Sincerely,

Marc S. Porter

Marc S. Porter
Managing Partner
Co-Chief Compliance Officer

Joseph Porzio

Joseph Porzio
Executive Vice President
FINOP

Alexandra Mihaescu
Senior Vice President
Director of Compliance

gkb George K. Baum & Company
INVESTMENT BANKERS SINCE 1928

March 28, 2014

Marcia E. Asquith
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, DC 2006-1506

Dear Ms. Asquith:

On behalf of George K. Baum & Company ("GKB"), I am pleased to submit this letter in response to the request for comments in Notice 14-02. Please also note that our firm is a member of both the Bond Dealers of America ("BDA") and the Securities Industry and Financial Markets Association ("SIFMA"). The BDA and SIFMA are submitting separate comment letters in response to the Request for Comment. GKB approves, endorses and supports the comments and suggestions being provided by them.

Covered Securities
FINRA's inclusion of specified MBS securities and CMOs disregards the very different nature and size of these markets in relation to systemic market risk. The specified MBS pool and CMO markets generally settle within a month and are not like TBA market in many respects: different and much more diverse market participants (eg. many more retail and investment advisor investors), much less speculation, and accordingly much less settlement and market risk (generally less than one month). For these and the cost issues discussed below, we urge FINRA to exclude these products from the proposed amendments to Rule 4210.

Retail Market Impact
A large number of participants in the specified MBS and CDO markets are smaller retail accounts and/or investment advisor accounts who will find the proposed maintenance margin requirements to be a barrier to their participation in these markets. The cost of establishing MSFTA agreements and requiring a maintenance margin deposit from them will therefore reduce both the breadth and depth of the market. For smaller broker dealers, the cost of establishing the required MSFTA documents with large numbers of small or retail accounts is operationally expensive and difficult at best. Further the additional operations costs to record, track and maintain margin accounts will require additional technology and personnel costs. Further, we believe that small and medium firms will be impacted mostly by the additional costs since they participate more broadly in these markets as compared to the TBA market.

Mortgage Origination Markets & Exempt Accounts
A significant percentage of the TBA market comes from mortgage origination platforms who use the TBA market to set their loan pricing and hedge their loan commitments for loans that will be delivered into a GNMA or FNMA security in 30/60/90 days. We believe that customers who use the TBA market solely to hedge their mortgage pipelines do not contribute to nor increase systemic risks in the market, and accordingly they should not bear the costs inherent in a proposed rule that is intended to control and mitigate systemic market risk. In these circumstances, any mark-to-market losses on the outstanding TBAs are generally matched by mark-to-market gains on the mortgage pipeline for the mortgage banking customer. Any increase in costs or additional capital needed by an entity that participates in the residential mortgage origination market will naturally lead to higher costs of mortgages for home buyers. Therefore, all other factors being held constant, the higher costs of hedging (in the form of margin

requirements) will be added to the costs of loans. While it is beneficial that mortgage pipeline hedging accounts are deemed to be Exempt accounts in the proposal (and therefore exempt from initial maintenance margin), the MTM margin requirement will require additional capital for mortgage origination entities without any reduction in systemic risk in the market.

In our opinion, no margin posting requirements should be required by a FINRA Rule for customer entities which use the TBA market in this manner. Firms should be given the flexibility to set their own counterparty exposure and margin requirement parameters for Exempt accounts, and any uncollateralized mark-to-markets should be handled by a reduction to Net Capital. We do not believe that the use of the TBA market for these purposes creates any additional or heightened market risk that needs to be addressed by additional rules from FINRA, particularly when the proposed rules will lead to a reduction in participation in these markets, higher costs and more concentration of risk in larger market participants.

Non FINRA Member Firms
If any participants in the TBA market (i.e. banks) are not subject to the same rules and restrictions set forth in the proposal, then FINRA member firms will undoubtedly be disadvantaged when competing with these other types of entities. Given the choice to trade with a counterparty which requires both an upfront margin and a maintenance margin versus one which does not, a market participant will always choose the one with lower or no margin requirements.

Cost Considerations
We understand that 99.7% of the par value of TBA trades are done by the top 50 firms. We believe that most of the risk is in these firms and not the smaller firms who deal in much smaller amounts. Against this background, the cost of purchasing or developing in-house the margining systems needed to track margin requirements on a daily basis is high. Early estimates we have seen indicate that a minimum of $100,000 per year is required to have a functional margining system, with some of the more robust systems costing in excess of $250,000 per year. This will make participating in the market place very difficult for any but the largest firms, again reducing the number of market participants and with it the breadth and depth of the market. The costs of daily pricing feeds from vendors is a substantial additional cost. The margining requirements will also require additional operational staff to run the systems, make the margin calls, monitor positions, etc. Again, smaller market participants will be forced to leave the market due to these significant additional costs.

Mismatch of Counterparty Credit Exposure
It is very typical for firms that work with many smaller entities or retail accounts on one side of a trade to then use a limited number of market participants or BDs on the other side to hedge those trades. This situation can create a potentially material mismatch in the margining requirements on the two sides of the trades. For example, consider the impact on a firm who has 100 smaller exempt accounts who buy or sell TBAs and other covered agency certificates securities on anything other than a T+1 basis. To hedge these trades with customers, the firm establishes MSFTAs with 4 different broker-dealers. In the simple example where each of the 100 accounts experience a margin maintenance requirement of $10,000 for a total of $1,000,000, then none of them would be required to post this maintenance margin given a minimum transfer amount of $250,000. On the other side, assuming the firm has perfectly hedged its positions, it would have to post $1,000,000 with its BD counterparties. This would require additional cash/capital of $1,000,000 just to make these margin calls, and would create an additional $1,000,000 decrease in net capital for the uncollateralized receivable from customers. This would not be a problem for larger firms, many who are members of MBSCC . However, this would impact the smaller to midsize entities the hardest and reduce the number of participants in these markets.

Ms. Marcia E. Asquith
March 28, 2014
Page 3 of 3

Conclusion
I urge FINRA to exclude specified MBS pools and CMO transactions from the proposal, to give member firms the flexibility to determine their own credit risk management and margining policies for Exempt accounts, and to not impose costly new operational rules which fall most heavily on small to mid-sized firms – the loss of which would substantially reduce both liquidity and market participation.

Thank you for the opportunity to comment on this important proposal.

Sincerely,

Dana L. Bjornson
Executive Vice President

INVESTMENT COMPANY INSTITUTE

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March 27, 2014

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

Re: Margin Requirements (Regulatory Notice 14-02)

Dear Ms. Asquith:

The Investment Company Institute ("ICI")[1] is submitting this letter in response to a request for comment by the Financial Industry Regulatory Authority ("FINRA") on the proposed amendments to FINRA Rule 4210 for transactions in the To Be Announced ("TBA") market.[2] The TBA Margin Proposal would require FINRA members carrying forward transactions with customers in "Covered Agency Securities"[3] to: (i) collect from non-exempt accounts both maintenance margin and variation margin and (ii) collect from exempt accounts[4] variation margin, subject to a minimum transfer amount

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[1] The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of $16.3 trillion and serve over 90 million shareholders.

[2] Margin Requirements, Regulatory Notice 14-02 (January 2014), available at http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p439087.pdf ("TBA Margin Proposal").

[3] The definition of "Covered Agency Security" would include TBA transactions, as defined in FINRA Rule 6710(u), for which the difference between trade date and settlement date is greater than one business day, certain mortgage pool transactions, as defined in FINRA Rule 6710(x), for which the difference between trade date and settlement date is greater than one business day and transactions in collateralized mortgage obligations, as defined in FINRA Rule 6710(dd), for which the difference between trade date and settlement date is greater than three business days.

[4] The term "exempt account" is defined in FINRA Rule 4210(a)(13) to include a number of institutional accounts, including registered investment companies. FINRA has expanded this definition with respect to certain types of transactions in Covered Agency Securities to include institutional investors that are independently audited entities with more than $1.5 million of net current assets and more than $1.5 million of net worth. *See* FINRA Rule 4210(e)(2)(F) /08, n. 2.

of $250,000.[5] The TBA Margin Proposal establishes a one-day time frame for posting of variation margin and a close-out requirement after five business days (even if a capital charge is taken) unless a customer posts variation margin.

ICI appreciates FINRA's concern that the lack of exchange of margin in the TBA market may create a potential for counterparty risk that could raise concerns about systemic risk to the financial markets. We strongly support FINRA's adoption of a rule that requires posting of variation margin for transactions between a broker-dealer and an exempt account. To mitigate the systemic risks identified by FINRA as the basis for the TBA Margin Proposal, it is essential, however, to modify the TBA Margin Proposal as follows:

- ***Require Two-Way Margining and Authorize Use of Tri-Party Custody Arrangements.*** The new rule should require broker-dealers to post variation margin to customers when Covered Agency Securities transactions are in-the-money to the customer and the customer, thus, is subject to payment and delivery risk of the FINRA member. In addition, the rule should allow investment companies registered under the Investment Company Act of 1940 ("ICA") to use tri-party custody arrangements both to hold posted margin in compliance with requirements of the ICA and to hold margin posted to the registered investment company by the broker-dealer for operational convenience.

- ***Revise the Definition of "Covered Agency Securities."*** Transactions settling within three business days should not be treated as Covered Agency Securities transactions because they do not pose material risk beyond the ordinary settlement cycle.

- ***Minimum Transfer Amount Should be Increased.*** The TBA Margin Proposal should be amended to raise the minimum transfer amount to $500,000 and eliminate any requirement that the FINRA member take a capital charge if it elects to rely on such minimum provided it has adopted appropriate risk limits, policies, and procedures.

- ***Eliminate the Close-Out Obligation.*** The TBA Margin Proposal should not result in the close-out of a Covered Agency Securities transaction for which the customer/counterparty has not posted margin within five business days of the call provided that the member firm takes a capital charge in lieu of collecting variation margin from an exempt account.

- ***Appropriate Transition Period.*** We request that customers and FINRA members be given at least one year to comply with the TBA Margin Proposal, once adopted.

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[5] FINRA proposes that the amount of any uncollected mark-to-market loss be deducted in computing the member's net capital at the close of business following the business day the mark-to-market loss was created.

We discuss all of these matters in more detail below.

Background

According to the TBA Margin Proposal, most trading of agency mortgage-backed securities ("MBS") takes place in the TBA market, which is characterized by transactions with forward settlements. The agency MBS market is one of the largest fixed income markets, and investment companies registered under the ICA ("registered funds") are significant investors in these instruments. Registered funds own a substantial amount of MBS with taxable bond funds holding the vast majority of those assets.[6] Investing in the TBA market also allows registered funds to obtain the desired mortgage exposures without having to own the underlying MBS directly.

As noted by FINRA, the exchange of margin in the TBA market has not been common practice. As a practical matter, broker-dealers have neither collected any variation margin or "mark-to-market loss" with respect to exempt accounts nor taken any capital charge in lieu of collateral.[7] We understand that broker-dealers have not been required to take the capital charge in lieu of collecting mark-to-market loss because of FINRA guidance that allows member firms not to take the capital charge if they have risk limits in place.[8] FINRA noted that this paradigm has created a potential for counterparty exposure that is inconsistent with the type of margining that is required for bilateral instruments entered into by institutional counterparties in other markets. FINRA also stated that the Treasury Market Practices Group ("TMPG") of the Federal Reserve Bank of New York adopted best practices recommendations that require margining of forward-settling agency MBS transactions by all counterparties, including "exempt accounts and broker-dealers."[9] In light of the growth of the TBA market, the number of participants and the credit concerns that have been raised in recent years, FINRA was of the view that there is a need to establish margin requirements for the TBA market that

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[6] As of September 30, 2013, registered funds held $553 billion in MBS. ICI Data.

[7] Under the current margining rules, broker-dealers are required to charge maintenance margin of 5 percent plus the mark-to-market loss to non-exempt accounts. For exempt accounts, broker-dealers are not required to charge either maintenance margin or initial margin but are required to collect the mark-to-market loss in the position or take a capital charge in lieu of collection of the mark-to-market loss.

[8] *See* TBA Margin Proposal, *supra* note 2, at 10 n. 15 ("To recap, Interpretation /03 of FINRA Rule 4120(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").

[9] TMPG, Best Practices for Treasury, Agency Debt, and Agency Mortgage-Backed Securities Markets, *available at* http://www.newyorkfed.org/tmpg/bestpractices_052313.pdf ("TMPG Best Practices").

will cover not only smaller investors (which are covered under the current rules)[10] but also cover larger, institutional investors that comprise the major part of the market.

Therefore, FINRA proposes to require its members to collect variation margin from exempt counterparties for transactions in Covered Agency Securities and to collect variation and maintenance margin equal to 2 percent of the market value of the securities from non-exempt accounts when the current exposure on the transaction exceeds $250,000. The TBA Margin Proposal suggests that the reference to "current exposure" relates only to the exposure that the broker-dealer has to the customer and not the exposure that the customer has to the broker-dealer.[11] Exempt counterparties generally include FINRA members, banks, savings associations, insurance companies, investment companies, states or subdivisions, pension plans, and persons meeting specified net worth requirements and other conditions.[12] Transactions cleared through a registered clearing agency and subject to margin requirements of the clearing agency would not be subject to the proposed requirements. Variation margin would be required only to the extent that the "current exposure" exceeded the minimum transfer amount of $250,000, subject to the broker-dealer taking a capital charge with respect to any uncollateralized mark-to-market loss below $250,000. Broker-dealers would be required to close out all customer positions for which a margin call has not been met within five business days even if the broker-dealer has taken a capital charge.

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[10] Under existing interpretive guidance, broker-dealers are required to impose a 5 percent margin requirement plus any mark-to-market loss on non-exempt accounts. *See* Exhibit I to Interpretations to FINRA rule 4210(e)(2)(F).

[11] The TBA Margin Proposal states that member firms might post margin to customers with respect to Covered Agency Securities transactions, but the proposed rule text does not require such posting. The TBA Margin Proposal also does not establish any operational framework to facilitate posting of collateral by broker-dealers to customers. *See, e.g.,* TBA Margin Proposal, *supra* note 2, at 4 ("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"). *See also id.* at 10 n. 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"). A customer will have "exposure" to the broker-dealer selling MBS to the customer throughout the life of the transaction because the customer is subject to the risk that the broker-dealer will not deliver the promised securities. The value of the customer's exposure increases to the extent that the purchase price for the securities agreed between the customer and the broker-dealer at inception of the transaction is lower than market value of the securities. FINRA refers to the difference between the customer's agreed purchase price and the market price of the referenced securities as the "unrealized gain" in the transaction. Similarly, the value of the broker-dealer's exposure to the customer increases to the extent that the purchase price for the securities agreed between the customer and the broker-dealer is higher than the market value of the securities. This difference is what FINRA refers to as the "mark-to-market loss in the position."

[12] *See* FINRA Rule 4210(a)(13) and FINRA Rule 4210(a)(4).

In addition, the TBA Margin Proposal would require FINRA members to make a determination in writing of a risk limit to be applied to each counterparty with which they engage in Covered Agency Securities transactions (although there is no indication that this risk limit could be used to eliminate a capital charge when a broker-dealer elects not to collect mark-to-market losses from exempt accounts). FINRA also proposes to establish a new reporting obligation with respect to concentrated credit exposures and a prohibition on entry into new Covered Agency Securities transactions that could increase credit exposure (from the broker-dealer's perspective) above designated thresholds.

Discussion

FINRA Should Require Two-Way Margining

To better protect counterparties of broker-dealers (which are treated by FINRA as "customers" of the member firm)[13] and the TBA markets generally, we strongly urge FINRA to require its members to post variation margin to their counterparties at the same level and in the same manner as required for the counterparty. This fundamental requirement also is consistent with the TMPG's Best Practices.[14] Two-way margin is critical to managing risk for Covered Agency Securities transactions as well as for the reduction of a build-up of systemic risk at institutions that engage in a significant number of these transactions. We believe that a two-way margining requirement protects counterparties (such as registered funds) and mitigates credit exposure and fail risk generally in the marketplace due to a concentration of TBA transactions at a limited number of broker-dealer firms. TBA transactions involve two-sided exposures in the same way as futures, options, swaps, repurchase transactions and securities lending transactions. The definition of "current exposure" included in the final rule should include the exposure that the customer has to the broker-dealer as well as the exposure that the broker-dealer has to the customer, and the rule should mitigate both of those exposures by requiring bilateral margining.

The daily collection of variation margin serves to remove current exposure from the TBA markets for all participants and to prevent exposures from accumulating. Two-way exchange of variation margin will provide protection to market participants against the market value losses that could otherwise build up at broker-dealers (*i.e.,* the entities that engage in significant volume of TBA transactions), which could threaten systemic stability in the financial markets.

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[13] TBA Margin Proposal, *supra* note 2, at 10 n. 14 ("Under the proposal, a "counterparty" is defined as any person that enters into a Covered Agency Securities transaction with a member and includes a "customer" as defined in paragraph (a)(3) of FINRA rule 4210").

[14] *See* TMPG Best Practices, *supra* note 9 at 3.

In connection with uncleared derivatives markets, we have consistently advocated for a two-way margining requirement globally to reduce systemic risk and promote central clearing.[15] We were gratified that the international regulators adopted a bilateral margining requirement as part of the final policy framework establishing minimum standards for margin requirements for non-centrally cleared derivatives.[16] The international standards recognize that two-way margin is an essential component of managing risk for derivatives transactions as well as for reducing systemic risk in the derivatives markets. We recommend that FINRA include this important protection in its proposed margin rule for the TBA market.[17]

FINRA Should Allow Independent Custodians to Hold Collateral Posted by Registered Funds

We request that registered funds be permitted to have their assets posted as variation margin for their TBA transactions to be held with an independent custodian. Use of a third-party, regulated U.S. bank custodian must be allowed where the counterparty posting collateral is a registered investment company. Under Section 17 of the ICA, registered funds are required to hold their assets (including

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[15] Letter from Karrie McMillan, General Counsel, ICI, and Dan Waters, Managing Director, ICI Global, to Wayne Byres, Secretary General, Basel Committee on Banking Supervision, Bank for International Settlements, and David Wright, Secretary General, International Organization of Securities Commissions, dated March 14, 2013, *available at* http://www.ici.org/pdf/27111.pdf; Letter from Karrie McMillan, General Counsel, ICI, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, dated February 4, 2013, *available at* http://www.ici.org/pdf/26967.pdf; Letter from Karrie McMillan, General Counsel, ICI, and Dan Waters, Managing Director, ICI Global, to Wayne Byres, Secretary General, Basel Committee on Banking Supervision, Bank for International Settlements, and David Wright, Secretary General, International Organization of Securities Commissions, dated September 27, 2012, *available at* http://www.ici.org/pdf/26529.pdf; Letter from Karrie McMillan, General Counsel, ICI, to David A. Stawick, Secretary, CFTC, dated September 13, 2012, *available at* http://www.ici.org/pdf/26500.pdf.

[16] Margin Requirements for Non-Centrally-Cleared Derivatives, Basel Committee on Banking Supervision and Board of the International Organization of Securities Commissions, September 2013, *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD423.pdf ("BCBS/IOSCO Report").

[17] In our view, FINRA has the necessary authority to require these changes and to require posting of margin by member firms just as FINRA clearly has authority to require member firms to collect maintenance and variation margin from customers (*i.e.,* in this case, "counterparties," because, as the TBA Margin Proposal explains, counterparties to Covered Agency Securities transactions are deemed to be "customers"). In the event that FINRA believes that it does not have authority to adopt a rule requiring FINRA member firms to post margin, we urge FINRA to request that the Securities and Exchange Commission ("SEC") adopt such a rule and require broker-dealers that enter into Covered Agency Securities transactions to post margin equal to the mark-to-market loss in the broker-dealer's position pursuant to the SEC's general authority to regulate margin under Section 7 of the Securities Exchange Act of 1934 ("Exchange Act") and its authority to regulate broker-dealers under Section 15 of the Exchange Act. We respectfully request that incorporation of a broker-dealer margin posting requirement be added as a condition to approval of the TBA Margin Proposal.

those posted as margin) with a qualified custodian, which typically must be a regulated bank.[18] Under the ICA, absent specific procedures and annual board approvals that are not practical for funds or specific SEC relief, registered funds are precluded from holding their collateral with a dealer that is not a bank. In addition, tri-party custody arrangements should be permitted for holding margin posted to a registered fund by a broker-dealer. As an operational matter, use of custodians to hold collateral posted by broker-dealers would be necessary because registered funds may not have the infrastructure to hold, oversee and invest (in the case of cash collateral) assets posted by broker-dealers as collateral to the registered fund.

More generally, we believe that tri-party arrangements provide important protection to all counterparties and operational safeguards and conveniences to the broker-dealers.[19] Use of these arrangements reduces operational risk by allowing parties to hold and transfer collateral through well-capitalized custodial banks, leveraging existing, industry-standard documentation and collateral management models that have worked efficiently in the over-the-counter swaps and repo (*i.e.,* "tri-party repo") contexts.

Specifically, tri-party custodian arrangements provide for the custodian to assume certain responsibilities with respect to safeguarding the interests of both counterparties, including maintaining custody of the collateral and being involved in effecting the transfer of funds and securities between the two parties. This arrangement helps to avoid market disruptions in the case of a default by a counterparty or other event necessitating access to the collateral. The protections provided to the counterparties from this structure are important to managing the risk created by exposure to a particular counterparty. These tri-party arrangements also can help prevent fraud and misappropriation of collateral. Similarly, this structure serves to reduce the bankruptcy and default risks in the financial system associated with a particular counterparty.

We have made similar comments to the SEC with respect to collateral posted by registered funds for their security-based swap transactions. We are enclosing a copy of our letter to the SEC, which provides detailed information regarding the arrangements currently in place for holding collateral of registered funds. We describe the protections provided by tri-party arrangements and explain how these arrangements afford dealers appropriate control over collateral posted by counterparties.

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[18] In addition to Section 17, the ICA contains six separate custody rules for the different types of possible custody arrangements: Rule 17f-1 (broker-dealer custody); Rule 17f-2 (self custody); Rule 17f-4 (securities depositories); Rule 17f-5 (foreign banks); Rule 17f-6 (futures commission merchants); and Rule 17f-7 (foreign securities depositories). Foreign securities are required to be held in the custody of a foreign bank or securities depository. Although Rule 17f-1 permits registered funds to use a broker-dealer custodian, the rule imposes conditions that are difficult in practice to satisfy.

[19] We understand that other types of counterparties (*e.g.,* separate accounts managed by investment advisers) also may prefer to use tri-party arrangements to hold collateral that they post to broker-dealers.

FINRA Should Modify the Definition of Covered Agency Securities

We request that the definition of "Covered Agency Securities" be modified to include only TBA transactions and Specified Pool Transactions for which the difference between trade date and contractual settlement date is greater than three business days rather than one business day as currently proposed. We believe that defining forward transactions to include transactions settling one business day after the trade date is inconsistent with the current margining regime for regularly-settled transactions. A broker-dealer has until T+5 to collect payment in a cash account for a purchase of securities before the position must be liquidated.[20]

Moreover, we believe that a requirement to margin TBA transactions and Specified Pool Transactions for which the difference between trade date and contractual settlement date is shorter than three business days would impose a cost that is wholly disproportionate with the risk. Although margining does reduce counterparty credit risk, it can introduce operational and other risks.[21] For example, the TMPG Report noted that operational aspects of margining would involve "middle-and back-office resources and systems . . . to mark unsettled positions using current and readily available pricing sources . . . . If securities were pledged as collateral, current pricing information and margin calls would be needed to ensure the sufficiency of the collateral. Systems and resources must also be prepared to communicate and respond to margin calls, reconcile possible disputes, and manage collateral flows and settlement."[22] As the TMPG Report recognized, there is a potential for mistakes or errors to occur in each step of the margining process, which should be considered in evaluating when margin requirements should apply. We agree with TMPG that it is critical to evaluate "the level and nature of operational risk that the [margining] process incurs"[23] and believe requiring counterparties to post margin against these instruments that settle in three days or fewer will create more systemic and operational risks than it will mitigate. If this requirement were to be adopted by FINRA, in many cases, counterparty collateral would be delivered to the broker-dealer after the transactions have settled, which would expose the counterparty to broker-dealer bankruptcy risk at a time when the broker-dealer

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[20] This five day period is consistent with the payment cycle for fully-paid security transactions. *See* Section 220.8(b) of Regulation T (requiring, for purchases in a cash account, payment within one "payment period" *(i.e.*, the three business days pursuant to SEC Rule 15c6-1(a)) plus two business days).

[21] *See* Report of the TMPG, Margining in Agency MBS Trading (November 2012) at 4, *available at* http://www.newyorkfed.org/tmpg/margining_tmpg_11142012.pdf (noting that margining would involve functions such as "measuring forward exposures, marking open positions, calculating the margin amount, communicating margin calls to counterparties, and delivering and receiving collateral") ("TMPG Report").

[22] *Id.* at 6.

[23] *Id.* at 5.

has no exposure to the customer and would create unnecessary costs of return and potential difficulties in identifying the settlement details for the broker-dealer.

Although settlement of more than three business days would, in our view, be the minimum time period that would be appropriate for a transaction to be treated as a Covered Agency Security transaction, we believe that longer time periods also may be appropriate. In that regard, we urge FINRA to consult with the economic and regulatory margining staff at the Board of Governors of the Federal Reserve System and the SEC's Division of Economic and Risk Analysis to better evaluate the point at which the risk mitigation from collateral posting would outweigh the operational risks and costs as well as the history of fails in Covered Agency Securities transactions. We believe that it is important for FINRA to address the fact that imposing margin requirements on customers introduces operational and other risks, which is appropriate only if the benefits from posting margin outweigh these risks.

FINRA Should Increase the Minimum Transfer Amount

FINRA proposes to require variation margin for transactions when the current exposure exceeds $250,000 and to require member firms to take a capital charge in respect of such "*de minimis* transfer amount."[24] Minimum transfer amounts are intended to balance the benefits of collecting variation margin against the operational risks in making frequent transfers of collateral. FINRA fully understood this balance in the TBA Margin Proposal when it states that it "recognized the potential operational burdens of collecting margin" and intended to impose a minimum transfer amount "consistent with other derivatives markets."[25]

We urge FINRA to increase the minimum transfer amount to at least $500,000, below which the counterparties would not have to exchange margin. We do not believe FINRA would achieve either of its articulated goals with the current amount. First, although we support FINRA's intention to propose a minimum transfer amount that is set sufficiently low to ensure that current exposure does not build up before variation margin is exchanged between counterparties, we do not believe amounts below $500,000 would result in significant build up of current exposure. Moreover, a minimum transfer amount that is set too low would result in more frequent transfers of collateral and increase the potential for operational risk as described above. Frequent transfers of collateral also would increase transaction costs. Second, the proposed minimum transfer amount would not be consistent with standards in the derivatives markets. Under the international agreed upon margin policy framework

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[24] TBA Margin Proposal, *supra* note 2, at 5 ("…FINRA proposes to provide for a minimum transfer amount of $250,000…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))."

[25] TBA Margin Proposal, *supra* note 2, at 5.

for uncleared derivatives, global regulators agreed to a €500,000 minimum transfer amount.[26] We expect U.S. regulators to propose a minimum transfer amount that is consistent with the international standards.[27]

Finally, we request that FINRA clarify that broker-dealers will not be required to take a capital charge with respect to customer exposure up to the minimum transfer amount. We believe that requiring broker-dealers to take a capital charge will eliminate the minimum transfer amount as a practical matter. In our experience, broker-dealers are generally unwilling to take a capital charge and, as a result, broker-dealers will elect to collect small amounts of variation margin rather than suffer a hit to capital. This modification will not in any way jeopardize the objectives of the new margining regime because the exposure due to the unsecured exposure underlying the minimum transfer amount is by definition "*de minimis.*"

FINRA Should Eliminate the Close-Out Obligation

FINRA proposes that if variation margin is not posted by a counterparty to secure the mark-to-market loss in respect to the counterparty's position within five business days from the date the loss was created, the member would be required to take promptly liquidating action unless FINRA grants the member an extension. Under the TBA Margin Proposal, liquidation would appear to be required even if the broker-dealer member were to take a capital charge.

In our view, this fails to recognize the efficacy of the capital charge. We believe that FINRA should retain its current interpretation that permits members to take a charge to net capital in lieu of collecting the mark-to-market loss from exempt accounts. Allowing broker-dealers to deduct the exposure from net capital would provide sufficient incentive for broker-dealers to collect variation margin from their counterparties without requiring them to close out the account within a set period of time. Reliance on capital charges to mitigate systemic risk when margin is not collected is a fundamental cornerstone of the SEC's and FINRA's financial responsibility rules for broker-dealers and security-based swap dealers.[28] There is no reason to believe that it would be less effective with

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[26] The BCBS/IOSCO originally proposed to subject counterparties to a minimum transfer amount not to exceed €100,000 but raised the minimum transfer amount to €500,000 when it issued its final policy framework. *See* BCBS/IOSCO Report, *supra* note 16.

[27] In 2011, the Commodity Futures Trading Commission proposed a minimum transfer amount of $100,000. This proposal was issued, however, before the proposal and adoption of the margin policy framework by the international regulators. Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 76 FR 23732 (April 28, 2011), *available at* http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2011-9598a.pdf.

[28] *See* Capital, Margin and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers, 77 FR 70214, 70242 (Nov. 23, 2012), *available at* http://www.gpo.gov/fdsys/pkg/FR-2012-11-23/pdf/2012-26164.pdf ("The proposed capital charge in lieu of margin is

respect to Covered Agency Securities transactions than it is in connection with other types of transactions.

Moreover, imposing a close-out obligation only on broker-dealers fails to recognize the bilateral exposure inherent in Covered Agency Securities transactions. Counterparties are exposed to the broker-dealer at all times yet FINRA does not propose to impose a similar punitive action for accounts for which a broker-dealer has failed to post variation margin. FINRA has not specified in any detail the rationale for proposing to amend its current position, and we urge FINRA not to retain this proposed requirement.

FINRA Should Recognize Offsets and Margin Reduction due to Unrealized Gains

FINRA should apply general netting and off-set principles to margining of Covered Agency Securities transactions just as it has done with respect to margining of similar transactions, such as "when issued" securities.[29] In addition, as FINRA has done in other contexts, the rule should provide, when calculating variation margin excess, that any mark-to-market gain in the Covered Agency Securities transaction benefitting the counterparty will be subtracted from the margin requirement and released to the counterparty or used to off-set other obligations.

FINRA Should Provide a One-Year Compliance Date

We are concerned that a six month compliance period would be too short to provide adequate time for market participants to prepare for the new requirements. Although market participants have in place written agreements for a significant portion of the TBA market, all of these agreements will have to be amended to reflect the new requirements adopted by FINRA. Tri-party custodial arrangements for registered funds also will have to be amended for every fund. There will be thousands of agreements that will have to be renegotiated and executed within the compliance period. In addition, a number of registered funds are not currently authorized to post collateral to broker-dealers under their existing investment policies. To post variation margin, these funds will need to obtain shareholder approval, which will take time to obtain. We do not believe six months would provide an adequate period of time for market participants to amend all the necessary agreements and to obtain the required shareholder approvals.

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designed to address situations where a nonbank SBSD does not collect sufficient (or any) collateral to cover potential future exposure relating to cleared and non-cleared security-based swaps"). *See also* SEC Rule 15c3-1(c)(2)(xii) (When a "pattern day trader" fails to meet special maintenance margin calls, as required (*i.e.*, within five business days from the date the margin deficiency occurs), on the sixth business day only, a member is required to deduct from net capital the amount of unmet maintenance margin calls for its pattern day traders); FINRA Rule 4210(e).

[29] *See* Rule 4210(f)(3)(A)/01 "Offsetting Position."

Finally, we are concerned that a short time period may result in dealers pressuring registered funds and other counterparties to sign agreements with unfavorable terms to complete the process before the compliance deadline. We do not believe it is appropriate to create a situation where registered funds and other counterparties are compelled to negotiate agreements to continue trading in these markets under the pressure of an unnecessarily short deadline.

* * *

We appreciate the opportunity to provide comments on FINRA's proposal to establish margin requirements for the TBA market. We believe that FINRA should incorporate the recommendations discussed above, which will make the margin requirements workable for market participants, including registered funds, and achieve FINRA's regulatory objectives. If you have any questions on our comment letter, please feel free to contact me at (202) 218-3563, Sarah Bessin at (202) 326-5835, or Jennifer Choi at (202) 326-5876.

Sincerely,

/s/

Dorothy M. Donohue
Acting General Counsel

cc: Stephen Luparello, Director, Division of Trading and Markets, SEC
Michael A. Macchiaroli, Associate Director, Division of Trading and Markets, SEC

Norm Champ, Director, Division of Investment Management, SEC
Doug Scheidt, Associate Director, Division of Investment Management, SEC

Enclosure

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December 5, 2013

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Re: *Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers (File No. S7-08-12) – Supplemental Comments to Letter of February 4, 2013 and Meeting with Staff on September 19, 2013*

Dear Ms. Murphy:

The Investment Company Institute ("ICI")[1] is pleased to provide additional information to supplement our letter of February 4, 2013 ("February Letter")[2] and meeting of September 19, 2013 regarding changes that we recommend the Securities and Exchange Commission ("Commission" or "SEC") make to its proposed capital, margin, and segregation requirements for security-based swap dealers ("SBSDs") and major security-based swap participants ("MSBSPs").[3] Specifically, we urge the Commission to include the following revisions in its final rules:

- Require bilateral exchange of collateral by SBSDs/MSBSPs and their counterparties.

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[1] The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of $16.1 trillion and serve over 90 million shareholders.

[2] Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, dated February 4, 2013, *available at* http://www.ici.org/pdf/26967.pdf.

[3] *Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers*, 77 FR 70214 (Nov. 23, 2012) ("Proposal"), *available at* *http://www.gpo.gov/fdsys/pkg/FR-2012-11-23/pdf/2012-26164.pdf* implementing regulations under Title VII of The Dodd Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank"), Pub. L. 111-203, 124 Stat. 1376 (2010).

- Not impose capital charges on SBSDs/MSBSPs[4] when their counterparties elect to have their collateral held at a third-party bank custodian.

- Permit all counterparties to post collateral for both cleared and uncleared security-based ("SB") swaps through a third-party bank custodian.

- Prohibit SBSDs from using funds in the customer reserve account held for one customer to benefit another customer.

- Allow counterparties to SB swaps to withdraw excess collateral from the special custody account at a third-party bank custodian securing their obligations.

- Permit the application of thresholds for initial margin.

These changes would significantly strengthen customer protections and incentivize SBSDs to act prudently when entering into SB swaps in recognition that they have a "stake in the game" (by virtue of the margin they must post). These revisions also would reduce operational risk by allowing parties to hold and transfer collateral through well-capitalized custodial banks, leveraging existing, industry-standard documentation and collateral management models that have worked efficiently in the over-the-counter swaps and repo (*i.e.,* "tri-party repo") contexts.

We again strongly urge the Commission to require SBSDs to post initial and variation margin to their non-SBSD counterparties at the same level and in the same manner as required for a non-SBSD counterparty. Adopting this fundamental requirement would make the SEC's margin rules consistent with the final policy framework issued by the Basel Committee on Banking Supervision ("BCBS") and the International Organization of Securities Commissions ("IOSCO") that establishes minimum standards for margin requirements for non-centrally cleared derivatives.[5] We believe it is imperative that the SEC not diverge from these internationally agreed standards, which are critical to the protection of counterparties (such as registered funds), the reduction of a build-up of systemic risk at institutions that engage in a significant amount of swap transactions, and the prevention of regulatory arbitrage. In the BCBS/IOSCO Report, BCBS/IOSCO explained that the group had determined that a greater reliance on margin would provide a more effective risk mitigant than imposition of higher

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[4] Although most MSBSPs would not be subject to a capital charge under the Proposal, the Proposal provides that MSBSPs that are dually-registered as broker-dealers would be subject to a charge. Proposal, *id.* at 70256 n. 466. In our view, neither these MSBSPs nor SBSDs should be subject to such a charge.

[5] *Margin Requirements for Non-Centrally-Cleared Derivatives*, Basel Committee on Banking Supervision and Board of the International Organization of Securities Commissions, September 2013, *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD423.pdf ("BCBS/IOSCO Report").

capital levels because: (i) margin is more targeted to a particular transaction and marketplace and is easy to adjust; (ii) capital is easily depleted whereas margin can be topped up, even intraday; (iii) margin allows for immediate liquidity; and (iv) requiring posting of collateral incentivizes more prudent behavior by market participants by forcing them to internalize the costs of risk taking.[6]

The remainder of this letter focuses on the SEC's proposed capital charge on an SBSD when its counterparty exercises its right to elect an independent bank custodian to hold collateral (which was specifically discussed at our September meeting).[7] We believe that an imposition of such a capital charge on an SBSD would result in adverse consequences and that such a result is unnecessary to satisfy the SEC's regulatory objectives for the reasons discussed below. We provide more detailed information regarding the arrangements currently in place for holding collateral of funds registered under the Investment Company Act ("ICA") that may be helpful to the SEC.

Specifically, this letter describes: (1) how the current tri-party agreements should satisfy the requirements under Proposed Rules 18a-3 and 18a-4; (2) the significant protections provided by the tri-party arrangements; (3) the current use of these arrangements and industry efforts to expand their use with the implementation of the Dodd-Frank requirements; and (4) terms we believe should be required in tri-party collateral agreements to address any residual concerns that the SEC may have regarding appropriate control by SBSDs over collateral posted by counterparties.

I. Background

In October 2012, the Commission proposed capital, margin, and segregation rules for SBSDs and MSBSPs that are modeled on existing rules applicable to broker-dealers. According to the Proposal, the collateral collection obligation, in connection with which the counterparties transfer collateral to SBSDs or MSBSPs in the form of initial margin or variation margin, is intended to provide the SBSD or MSBSP with sufficient margin to cover the SBSD's (or MSBSP's) exposure to the counterparty on a cleared or bilateral SB swap in the event of counterparty default and liquidation of the position.[8]

Even though Dodd-Frank expressly requires SBSDs and MSBSPs to allow counterparties to hold initial margin posted in respect to non-cleared SB swaps at an independent, third-party custodian, the Proposal discourages exercise of this right and treats SB swap positions for which collateral is held

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[6] *Id.* at 3.

[7] *See* Protection of Collateral of Counterparties to Uncleared Swaps; Treatment of Securities in a Portfolio Margining Account in a Commodity Broker Bankruptcy, 78 FR 66621, 66623 (Nov. 6, 2013) ("CFTC Protection of Collateral Release") (CFTC recognized that "Congress' description as a 'right' of what would otherwise be a simple matter for commercial negotiation suggests that this decision is an important one, with a certain degree of favor given to an affirmative election").

[8] Proposal, *supra* note 3, at 70246.

through a third-party custodian the same way as an uncollateralized position by requiring the SBSD and certain MSBSPs to take a capital charge because the collateral is held away.[9] The Commission explained that this proposed capital charge was necessary because collateral held through a custodian would be insufficient to protect the SBSD from losses if the counterparty defaults. The SEC reasoned that the collateral would not protect the SBSD because the SBSD would not have physical possession or control over the collateral or be able to liquidate the collateral promptly without intervention of another party.[10]

We respectfully disagree with the SEC's analysis for the reasons described below. We believe the SEC should seek to fulfill Congress' intent and encourage use of independent, third-party custodial arrangements to hold both initial and variation margin, subject to compliance with state uniform commercial code requirements and provision by custodians of the types of collateral transfer and reporting safeguards provided currently in the tri-party repo market.[11]

Moreover, as discussed in our February Letter, registered funds may be precluded from holding their collateral with an SBSD or MSBSP that is not a bank. Under the ICA, registered funds are required to custody their assets in accordance with Section 17 of the ICA. Nearly all registered funds use a U.S. bank custodian for domestic securities although the ICA permits other limited custodial arrangements.[12] Rule 17f-1 permits registered funds to use a broker-dealer custodian, but the rule imposes conditions that are difficult in practice to satisfy. We do not believe that complying with the protective requirements under the ICA (and electing the right specifically provided by Dodd-Frank) should result in higher costs to registered funds, especially when third-party custodial arrangements would achieve the SEC's regulatory objectives.

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[9] *See id.* at 70246.

[10] *Id.* at 70246 – 70247.

[11] We also request that the Commission clarify in any rule it ultimately adopts that it would be permissible for counterparties to hold cleared SB swaps and related collateral through a custodial bank that is a member of a SB swap clearinghouse, regardless of whether the custodial bank is an SBSD. The rule also should clarify that the custodial bank would be authorized to hold all excess counterparty margin in a segregated account in the counterparty-customer's name and post with the clearinghouse the counterparty's required margin for the cleared SB swap.

[12] In addition to Section 17, the ICA contains six separate custody rules for the different types of possible custody arrangements: Rule 17f-1 (broker-dealer custody); Rule 17f-2 (self custody); Rule 17f-4 (securities depositories); Rule 17f-5 (foreign banks); Rule 17f-6 (futures commission merchants); and Rule 17f-7 (foreign securities depositories). Foreign securities are required to be held in the custody of a foreign bank or securities depository.

II. Tri-Party Collateral Agreements Satisfy the Requirements of Proposed Rules 18a-3 and 18a-4

Collateral posted for non-cleared swaps must meet certain conditions under Proposed Rule 18a-3 for a nonbank SBSD to count the collateral as equity in the counterparty's collateral account. One of the six conditions requires that the collateral be subject to "the physical possession or control of the nonbank SBSD and capable of being liquidated promptly by the nonbank SBSD without intervention by any other party."[13] Proposed Rule 18a-4(b) also expressly requires that "excess securities collateral" posted to any type of SBSD[14] in respect to either a cleared or a non-cleared swap be in the "physical possession or control" of the SBSD. Excess securities collateral includes initial margin and all other collateral in excess of the SBSD's exposure to the counterparty.

The requirement in the Proposal for "physical possession or control" allows collateral to be held either at the SBSD (*i.e.*, in its "physical possession") or at a third party so long as the collateral is under the "control" of the SBSD. In the broker-dealer context, the Commission has interpreted "control" to require that securities be held in one of several locations specified in Rule 15c3-3 and that the securities be free of liens and other restrictions that could impede the ability of the broker-dealer to liquidate the securities.[15] Permissible locations include banks.[16] As discussed below, a careful analysis of properly-structured, tri-party collateral arrangements indicate that they satisfy the SEC's definition of "control."

A. Tri-Party Collateral Arrangements Provide the Secured Party with "Control" over the Collateral.

Although an SBSD would not have physical possession of securities collateral under a tri-party custodial arrangement, the SBSD would have legal "control" over the securities and cash pledged to it but held by the custodian so long as the arrangement were structured to comply with Articles 8 and 9 of the Uniform Commercial Code ("UCC"). Section 8-106(d)(2) of the UCC provides that a secured party has "control" of a "security entitlement" if: "the securities intermediary has agreed that it will comply with entitlement orders originated by the … [secured party] without further consent by the entitlement holder." In explaining the provision, the drafters noted that the provision allows a secured party that holds collateral through a "securities intermediary" to have control over the securities account and the assets held in the account, regardless of whether the intermediary is a custodian for the

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[13] *See* paragraph (c)(4)(i) of Proposed Rule 18a-3 under the Securities Exchange Act of 1934 ("Exchange Act").

[14] These include: bank SBSDs, stand-alone SBSDs and broker-dealer SBSDs.

[15] Proposal, *supra* note 3, at 70276 – 70277 and n. 665 (citing 17 CFR 240.15c3-3(c)).

[16] *Id.* at 70276-70277

pledgor or for the secured party.[17] Section 9-104 of Article 9 provides a similar right in respect to security entitlements over deposit accounts holding cash collateral. The term "security entitlement" is a property right that a person obtains in the contents of a securities account with a "securities intermediary."[18] The concept of "security entitlement" provides a holder of the entitlement with a priority in the financial assets held in that account over the securities intermediary or the security intermediary's creditors.[19]

Article 8, which covers security interests in securities, was expressly adopted to provide more certainty to borrowers and lenders in light of changes in the manner in which securities are held. The determination of whether the secured party has a security interest in securities that have been posted as collateral depends upon whether the secured party has the present ability to have the securities sold or transferred without further action by the transferor. These rights are not required to be exclusive, and the secured party may (but is not required to) allow the debtor to retain rights of disposition over the account or securities, including through the right to substitute collateral. Moreover, the rights of the third party are not required to "spring" into being only upon a pledgor's default but can be in place throughout the term of the tri-party collateral arrangement.[20] "Control" is based on the contractual agreement directing the custodian to follow instructions from the secured party with respect to the custody account without first obtaining consent from the entitlement holder.

In practice, pledgors and secured parties memorialize the pledge of securities and the grant of "control" to the secured party through an "account control agreement" among a pledgor, secured party and securities intermediary. As required by condition (ii) of Proposed Rule 18a-3 applicable to nonbank SBSDs with respect to collateral collected for non-cleared SB swaps and the more general requirements of Proposed Rule 18a-4, the agreement allows collateral to be liquidated promptly by the secured party-SBSD without intervention by any other party.[21]

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[17] *See* UCC Official Comments to Section 8-106, Comment 4 ("Subsection (d)(2) provides that a purchaser has control if the securities intermediary has agreed to act on entitlement orders originated by the purchaser if no further consent by the entitlement holder is required. Under subsection (d)(2), control may be achieved even though the transferor's original entitlement holder remains listed as the entitlement holder").

[18] *See* UCC Section 8-102(a)(17) ("Security Entitlement means the rights and property interest of an entitlement holder with respect to a financial asset specified in Part 5").

[19] Uniform Law Commission, the National Conference of Commissioners on Uniform State Laws, UCC Article 8, Investment Securities (1994) Summary. *See* UCC Section 8-102(a)(14) (Security Intermediary means (i) a clearing corporation; or (ii) a person, including a bank or broker, that in the ordinary course of its business maintains securities accounts for others and is acting in that capacity").

[20] UCC Official Comments to Section 8-106, Comment 7.

[21] Proposed Rule 18a-3(c)(4)(iii).

Under a typical control agreement, the secured party will have an unconditional right to dispose of the assets upon any triggering event, such as the pledgor's default or the pledgor's failure to maintain sufficient equity in the collateral account. The secured party also will have the right to exclusive control over the account simply by delivering a notice of exclusive control to the custodian, which the custodian has no right to question.

To provide protection to the pledgor against overreaching by the secured party, the secured party will typically covenant to the pledgor that it will not submit a notice of exclusive control or seek to exercise remedies in respect to the pledged securities account and securities in the account unless the pledgor has defaulted or there has been a similar triggering event, such as a termination event or "specified condition" under the Master Agreement published by the International Swaps and Derivatives Association, Inc. ("ISDA").[22] This approach provides certainty to the parties because it ensures that the securities intermediary will follow the instructions of the secured party.[23]

Courts have recognized the legitimacy of collateral control arrangements and enforced them in accordance with their terms,[24] noting that, to view the arrangements in any other light would be to ignore commercial reality.[25] This recognition of tri-party collateral arrangements by the courts ensures that condition (c)(4)(iv) of Proposed Rule 18a-3 would be met by relying on a properly drafted control agreement.[26]

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[22] The concept of a "Specified Condition" is included in the ISDA Credit Support Annex as a trigger for exercise of default remedies by the secured party under the ISDA Credit Support Annex. The triggering events are subject to definition by the parties through designation in Paragraph 13 of the ISDA Credit Support Annex.

[23] *See* UCC Official Comments to Section 8-106, Comment 7 ("In many situations, it will be better practice for both the securities intermediary and the purchaser to insist that any conditions relating in any way to the entitlement holder be effective only as between the purchaser and the entitlement holder. That practice would avoid the risk that the securities intermediary could be caught between conflicting assertions of the entitlement holder and the purchaser as to whether the conditions in fact have been met. Nonetheless, the existence of unfulfilled conditions effective against the intermediary would not preclude the purchaser from having control").

[24] *See Scher Law Firm v. DB Partners I LLC*, 27 Misc.3d 1230(A), 911 N.Y.S.2d 696 (Kings County 2010) (finding that a broker-dealer's security interest in collateral was perfected by the control agreement, and the broker-dealer obtained control over the collateral pursuant to the control agreement in accordance with the requirements of UCC 8-106(d)); s*ee also SIPC v. Lehman Brothers Inc.,* 433 B.R. 127 (Bankr. S.D.N.Y. 2010) (rejecting an argument by a pledgor of collateral to a bankrupt broker-dealer under a control agreement that the pledged collateral should be excluded from the definition of "customer property" under the Securities Investor Protection Act ("SIPA") because the assets were not in the "possession" of the debtor and, thus, never "held" by the debtor. The Court found that the assets held under the tri-party agreement "were under the dominion and control of [the debtor]").

[25] *SIPC v. Lehman Brothers Inc, supra* note 24 (noting as well that failure to enforce the control provided to a secured party over collateral held through a properly-documented, tri-party custody arrangement "disregards the commercial reality of the agreements among the parties").

[26] Proposed Rule 18a-3(c)(4)(iv).

B. Tri-Party Collateral Arrangements Satisfy the Requirements that the Assets be Held Free of Liens and Held at an Appropriate Location

According to the SEC, the term "possession or control," as used in Rule 15c3-3, means that a broker-dealer may not lend, rehypothecate or use the referenced assets in its business.[27] Collateral posted through a third-party custodian and held in a special custody account would be held free of liens, other than the lien imposed by the agreement in favor of the secured party.[28] Under the tri-party arrangement, similar to the requirement for broker-dealers under Rule 15c3-3, the secured party could not lend, rehypothecate or use these assets in its business.

Allowing SB swap counterparties to post securities and other collateral through a special custody account at third-party bank custodian would be consistent with the requirement under Proposed Rule 18a-3 that the instruments be held in one of five specified ways – one of which is to be "in the custody or control of a bank as defined in section 3(a)(6) of the [Exchange] Act."[29]

III. Tri-Party Collateral Arrangements Incorporate Significant Protections for Secured Party and Pledgor

A. Tri-Party Collateral Arrangements Provide Protections Against Operational Risk

By centralizing margin operations at a custodial bank, counterparties can more easily standardize transfer times, minimize transfer errors, facilitate cross-product netting of collateral posted and received and provide for transparency through online custodial systems and confirmations. As the custodial banks have proven in the tri-party repo market, they are well positioned to process multiple transactions simultaneously on their books and offer streamlined and automated collateral allocation and substitution capabilities.[30] Custodial banks also can offer economies of scale to counterparties and efficiencies based on the fact that they have existing systems to handle margining and appropriate staffing levels and expertise. Because the custodian is independent, custodial employees also may not have an incentive to expropriate customer margin if the SBSD experiences liquidity issues (*e.g.*, as was the case with MF Global).

By leveraging custodial infrastructures to handle margin transfers, investment of cash, and recordkeeping, counterparties can ensure that collateral is posted and returned (when no longer

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[27] Proposal*, supra* note 3, at 70278.

[28] In some cases a collateral control agreement will include a lien in favor of the custodian sufficient to cover advances made by the custodian or the custodian's fees. Where this is included in the agreement, the secured party will typically require that the custodian subordinate its lien to that of the secured party.

[29] Proposal*, supra* note 3, at 70351.

[30] Task Force on Tri-Party Repo Infrastructure, Payments Risk Committee, Final Report, February 15, 2012.

needed) quickly and efficiently, and collateral posting can be minimized through netting collateral postings across positions and establishing a net equity (in a similar manner as contemplated by Regulation T and Rule 4210 of the Financial Industry Regulatory Authority ("FINRA") in respect to broker-dealer margin accounts).[31] In addition, from an operational perspective, custodians significantly improve the margining process by facilitating efficient management of collateral (whether posted by a counterparty or an SBSD or MSBSP), transparency into collateral positions and robust operational infrastructures. Therefore, contrary to the Proposal's suggestion that custodial arrangements increase systemic risk and, in particular, solvency risk in respect to SBSDs, the use of custodial arrangements reduces systemic risk, enhances the audit trail and ensures that security interests are properly perfected and available for a secured party to act on as a result of the "control" of collateral provided to the SBSD or MSBSP by the tri-party arrangement.

B. Collateral Held by a Custodian Allows the Pledgor (including an SBSD or MSBSP Posting to a Counterparty) to Manage Its Portfolio

Section 4(d) of the 1994 (New York Law version) ISDA Credit Support Annex, which is the collateral agreement customarily used by SBSDs, MSBSPs, and SB swap counterparties in the United States, provides for substitution of collateral upon notice to, but without consent from, the secured party. Although this provision may be modified by parties in Paragraph 13 of the Annex, the default provision allows for free rights of substitution of collateral. In practice, this provision allows the pledgor flexibility to reinvest collateral while maintaining collateral in the required amount at the custodian. This flexibility ensures that a pledgor – whether an SBSD, MSBSP or counterparty – can efficiently and effectively manage its portfolio and use its assets, even when those assets are subject to a lien. These arrangements mitigate the risk that posting of collateral, particularly by an SBSD or MSBSP, will cause a "liquidity drain."[32] All of the major bank custodians have built on-line systems that provide real-time transparency into the substitution process, which benefits both the secured party and pledgor.

[31] For a rule authorizing consolidation and netting across accounts, see FINRA Rule 4210(f)(5)("When two or more accounts are carried for a customer, the margin to be maintained may be determined on the net position of said accounts, provided the customer has consented that the money and securities in each of such accounts may be used to carry or pay any deficit in all such accounts").

[32] *See* Proposal, *supra* note 3, at 70267 (noting that commenters to margin proposals published by the Commodity Futures Trading Commission ("CFTC") and the bank regulators indicated that requiring segregation of initial collateral, in particular, would cause "a massive liquidity drain" and would harm the marketplace by limiting the availability of swap collateral).

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C. Use of Tri-Party Collateral Arrangements Makes Customer Assets Readily Identifiable in Bankruptcy

Congress added an express segregation right for counterparties to SBSDs and MSBSPs for their non-cleared swaps initial margin to provide greater protections to counterparties upon the bankruptcy of an SBSD or MSBSP.[33] The SEC described the intent of segregation as generally facilitating identification of customer assets upon a broker-dealer's bankruptcy and increasing the possibility that the assets will be physically available at the bankrupt broker-dealer to be returned to the customer or transferred to a solvent institution.[34]

Bankruptcy treatment of SB swaps is subject to some uncertainty. SBSDs are subject to the stockbroker liquidation provisions of the U.S. Bankruptcy Code ("Bankruptcy Code"),[35] and Dodd-Frank suggests – although it has not yet been decided by a bankruptcy court – that both cleared and uncleared SB swaps and the related collateral should be deemed "securities accounts" as defined in the stockbroker liquidation provisions.[36] It is also not clear whether the SB swap positions and related collateral would be considered to be customer property for purposes of SIPA, which SBSDs may opt into by voluntarily becoming a member of the Securities Investor Protection Corporation ("SIPC"). The Proposal addressed the uncertainty in treatment under the Bankruptcy Code and under SIPA by requiring counterparties of SBSDs who have elected to segregate initial margin to agree to subordinate their claims against the SBSD to the claims of all SB swap counterparties of the SBSD to the extent that the segregated assets are not treated as customer property in a liquidation of the SBSD.[37]

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[33] Proposal, *supra* note 3, at 70275 ("The objective of individual segregation is for the funds and other property of the counterparty to be carried in a manner that will keep these assets separate from the bankruptcy estate of the SBSD or MSBSP if it fails financially and becomes subject to a liquidation proceeding. Having these assets carried in a bankruptcy-remote manner protects the counterparty from the costs of retrieving assets through a bankruptcy proceeding caused, for example, because another counterparty of the SBSD or MSBSP defaults on its obligations to the SBSD or MSBSP").

[34] Proposal, *supra* note 3, at 70276 ("Rule 15c3-3 requires a broker-dealer that maintains custody of customer securities and cash (a 'carrying broker-dealer') to take two primary steps to safeguard these assets. The steps are designed to protect customers by segregating their securities and cash from the broker-dealer's proprietary business activities. If the broker-dealer fails financially, the securities and cash should be readily available to be returned to the customers. In addition, if the failed broker-dealer is liquidated in a formal proceeding under SIPA, the securities and cash should be isolated and readily identifiable as 'customer property' and, consequently, available to be distributed to customers ahead of other creditors").

[35] Proposal, *supra* note 3, at 70274.

[36] *Id*. The term "securities account" is used in Section 741 of the Bankruptcy Code in defining the terms "customer" and "customer property."

[37] The logic of requiring subordination is that the counterparty should not need the benefit of priority status with respect to posted collateral upon the bankruptcy of an SBSD because the segregated assets should be treated as bankruptcy remote as a result of the tri-party arrangement. In light of the uncertainty regarding treatment in bankruptcy, the SEC added this conditional waiver and provided that, if the segregation is not effective in treating the counterparty assets as being outside of the bankruptcy estate, then the counterparty will be treated as having a *pro rata* priority claim to customer property. *See* Proposed Rule 18a-4 and Proposal, *supra* note 3, at 70287-70288.

In light of the clear intention of Congress to provide greater protection to counterparties to non-cleared SB swaps in bankruptcy of an SBSD or MSBSP by the grant of a segregation right for initial margin, the Commission should encourage the use of the existing right of segregation under section 3E(f) of the Exchange Act by not imposing capital charges. The Commission should provide for expanded use of tri-party arrangements, in respect to both initial and variation margin. The broader availability of tri-party arrangements would protect all types of counterparties to SB swaps (including SBSDs and MSBSPs) upon the bankruptcy of the counterparty to which their collateral has been pledged. The fact that the bankruptcy treatment of counterparty assets upon the bankruptcy of an SBSD is subject to some uncertainty is not a reason to reject this approach. The Commission has addressed the uncertainty through its proposed subordination requirement. Moreover, it is clear that counterparties as well as the market generally would benefit as result of the stronger and more equitable bankruptcy process that would be possible when counterparty property is readily identifiable, not commingled with assets of the debtor and not available for misuse by the debtor as it is heading towards insolvency.

IV. Use of Tri-Party Collateral Arrangements is Well Understood by Market Participants and Will Likely be Expanded with Implementation of Dodd-Frank Rules

Control agreements are widely used with respect to non-cleared derivatives transactions. As noted above, registered funds are required to use these arrangements to comply with Section 17(f) of the ICA.[38] Pension funds and other institutional investors often rely on the arrangements as well. Control agreements typically include standard, contractual terms that make clear that collateral is pledged for the benefit of the secured party and ensure that both the pledgor and secured party have the benefits of the arrangement but are protected against misuse of the collateral by the other party.

ISDA recently published a standard form of control agreement as a result of a three-and-a-half-year long project involving dealers, buy-side counterparties and custodians.[39] The ISDA model form is designed to be supplemented by an annex that is agreed between the parties so that the agreement may be customized.[40] The model form is clear, easy to negotiate (since the Annex includes selection menus) and fully compliant with UCC requirements to ensure that the secured party has a perfected priority security interest in the collateral.

Tri-party arrangements are tailored to work with the ISDA master agreement and other standard documentation to provide predictability regarding default and early termination triggers and

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[38] *See supra* note 12 and accompanying text.

[39] Although the ISDA form of control agreement was designed for use in connection with posting of initial margin by the counterparty, the form could be adopted for other situations, including for posting of variation margin by the counterparty and for posting of both initial and variation margin by the dealer.

[40] *See ISDA Publishes ISDA 2013 Account Control Agreement (ACA)* at press@ISDA.org.

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remedies. The documentation allows a secured party to act quickly in liquidating collateral so as to mitigate market risk. Under the 2002 ISDA Master Agreement, bankruptcy defaults take effect without notice although other defaults, as well as termination events, require written notice by the non-defaulting party to the defaulting party. Payments are due with respect to defaults on the date specified by the non-defaulting party (which may be the date of the bankruptcy or notice) or two business days later, with respect to a termination event. Standard control agreements, including the ISDA model template, provide for immediate enforcement of a notice of exclusive control by the custodian so that a defaulting party may not withdraw assets. There is little or no practical difference in timing between exercise of default remedies when collateral is held under a custodial arrangement and when collateral is held directly by a secured party.

V. Recommended Terms to Include in Tri-Party Collateral Arrangements

For the reasons discussed above, we believe that the Commission should confirm that tri-party agreements satisfy the requirements in Proposed Rules 18a-3 and 18a-4. If the Commission believes certain mandatory terms are necessary in such agreements,[41] we recommend the following provisions for the protection of both counterparties:[42]

- *Account Plating.* A control agreement would provide that the account be appropriately labeled by the custodian to reflect the pledge relationship, the name of the secured party and the name of the pledgor (i.e., "[Name of Pledgor] for the benefit of [Name of Secured Party], as pledgee"). Labeling in this manner: (i) clarifies that the pledgor has pledged and not sold the assets; (ii) avoids confusion from a tax perspective regarding beneficial ownership; and (iii) identifies the lien and nature of secured party's interest in the account.
- *Compliance with Entitlement Orders.* The control agreement would prohibit the custodian from accepting instructions with respect to the account from persons other than the secured party and the pledgor. Until the occurrence of an event of a default, termination event or "specified condition" under the ISDA Master Agreement[43] between the secured

[41] We recommend that the Commission require that segregation be subject to a written agreement that includes the custodian as a party. *See* CFTC Protection of Collateral Release, *supra* note 7, at 66627 (CFTC recently adopted rules to require written agreements that include the custodian as a party in respect to tri-party arrangements for initial collateral for swaps).

[42] The ISDA model form includes all of the protective provisions described below (other than collateral substitution, which is addressed in the ISDA Credit Support Annex rather than in the model control agreement).

[43] "Termination events" are defined in Section 5(b) of the ISDA Master Agreement and include events such as illegality, force majeure and events that the parties define, such as a debt ratings downgrade or a drop in a party's net asset value. The term "specified condition" is defined in the Credit Support Annex to the ISDA Master Agreement to mean an event that excuses obligations of parties to post or return collateral and triggers a right to terminate the affected transactions. Specified conditions are selected by parties to the Master Agreement, and include events such as illegality, a change in tax laws, and a credit deterioration as a result of a merger.

party and the pledgor (a "Notice of Exclusive Control" or "NEC Event"), the custodian would be allowed to accept instructions from both the secured party and the pledgor. The secured party would covenant not to issue such instructions unless and until the occurrence of an NEC Event, but the custodian would be obligated to follow instructions even if the secured party breached its covenant. In the absence of an NEC Event, the pledgor would agree with the secured party to provide only limited instructions allowing it to substitute collateral of equal value in accordance with procedures agreed with the secured party. The control agreement would clearly prohibit the custodian from accepting any further instructions from the pledgor upon the occurrence of an NEC Event.[44]

- *Specified Withdrawal Rights.* A control agreement would include a restriction on the ability of the pledgor to withdraw collateral except in the event that the pledgor simultaneously substitutes for the withdrawn collateral eligible collateral of equal value.
- *Notice of Exclusive Control.* A control agreement would include a provision allowing the secured party to obtain exclusive control over the pledgor's posted collateral through an NEC. The terms would specify that custodian has no right to question the right of the secured party to submit the NEC, and the custodian would be obligated, upon receipt from the secured party to do so, immediately to turn over possession of the collateral to the secured party and take any other steps requested to liquidate the collateral and use such proceeds to pay to the secured party all amounts owed by pledgor. The agreement would include a covenant by the secured party not to submit an NEC unless an NEC Event has occurred and is continuing.
- *Custodian Covenants.* A custodian would be required to covenant not to hold a lien over the account or its assets or if the parties agree that custodian may have a limited lien (*e.g.*, to cover custodial fees and overdraft lines), the custodian would expressly subordinate its right and lien to that held by secured party.[45]

With respect to other "margin" accounts, the broker-dealer community has at times been reluctant to allow customers to post margin and collateral through a tri-party custody arrangement for

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[44] This language typically reads as follows: "The Custodian hereby acknowledges the security interest granted to Secured Party by Pledgor in the Posted Collateral. The Custodian will comply with the "entitlement orders" (as defined in Section 8-102(a)(8) of the Uniform Commercial Code of the State of New York) concerning the Account originated by Secured Party without further consent by Pledgor until this Agreement is terminated as provided herein. Except for substitution of collateral, as provided in section ____, the Custodian agrees not to act on entitlement orders or other instructions originated by any other person with respect to the Account unless it has received the prior written consent of the Secured Party."

[45] Other provisions that counterparties and dealers often require in connection with tri-party collateral arrangements are: (i) a representation that the custodian is not an affiliate of either of the other parties; (ii) a representation that the custodian is a bank, as defined in the Exchange Act; and (ii) a covenant by the custodian to hold the collateral in the United States.

securities margin accounts because these arrangements restrict the ability of the broker-dealers to freely use customer collateral to finance their own operations. Because of these concerns, broker-dealers have recommended that the tri-party arrangements that are required to be used with respect to collateral posted by registered funds be subject to a number of unnecessary requirements that are inconsistent with the requirements on registered funds and do not reflect the realities of commercial law. For example, broker-dealers have proposed that (1) customers not be allowed to withdraw assets from the account even though the assets are in excess of the applicable margin requirements,[46] (2) collateral substitutions and investments of customer cash in money market instruments be prohibited unless the broker-dealer provides an instruction allowing for such withdrawals,[47] and (3) broker-dealers be able to freely use and invest the collateral for their own benefit (*i.e.,* rehypothecate the posted collateral).[48] We recommend that the SEC not adopt these or impose any other restrictions on tri-party arrangements beyond those we have suggested above. We believe concerns about broker-dealer financing should not be addressed by imposing unnecessary requirements on tri-party arrangements and such unnecessary terms should not be carried over to tri-party collateral arrangements for SB swap transactions.

VI. Conclusion

We strongly urge the Commission to recognize and encourage the use of tri-party collateral arrangements for both initial and variation margin in connection with both cleared and non-cleared SB swaps. In addition, the Commission should not impose a capital charge on an SBSD or MSBSP for transactions for which its counterparty elects to have its collateral held at an independent custodian. A capital charge is unnecessary given the legal recognition that a secured party under a tri-party control agreement has the same right to control the collateral as if the secured party held physical possession of the collateral or held the collateral in an account in the secured party's name at its own custodian.[49] Imposing a capital charge also is inconsistent with the intent of Congress in granting an explicit right, under the Dodd-Frank Act, for counterparties to hold initial margin at an independent, third-party custodian.

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[46] This limitation is stricter than the rules regarding customer withdrawals from margin accounts under Regulation T and FINRA Rule 4210, which allow for withdrawals without consent. *See, e.g.,* FINRA Rule 4210(b).

[47] As discussed above, the flexibility to provide for substitution of collateral and investment of cash in money market instruments is important to fiduciaries in managing registered funds or other types of funds and customer assets to manage the portfolio and provide for reasonable returns on the posted collateral.

[48] Compare this term to Rule 17f-6 under the ICA, which provides that margin delivered to a futures commission merchant ("FCM") by a registered fund may be invested by the FCM only in accordance with strict limitations provided under rules of the CFTC.

[49] UCC Official Comments to Section 8-106, Comment 7.

We appreciate the opportunity to provide supplemental comments on the Proposal. If you have any questions on our comment letter, please feel free to contact me at (202) 326-5815, Sarah Bessin at (202) 326-5835, or Jennifer Choi at (202) 326-5876.

Sincerely,

/s/

Karrie McMillan
General Counsel

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The Honorable Luis A. Aguilar
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March 28, 2014

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FINRA
1735 K Street, NW
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Re: Comments to FINRA Rule 4210 for Transactions in the TBA Market

MetLife recognizes the substantial effort and consideration that the Financial Industry Regulatory Authority ("FINRA") has dedicated to ensuring a more resilient financial system by proposing margin requirements for transactions in the To Be Announced ("TBA") market (the "TBA Market") and appreciates the opportunity to comment on the proposed amendments to FINRA Rule 4210 for transactions in the TBA Market (the "Proposal").

MetLife, Inc. is the holding company of the MetLife family of insurance companies. The MetLife organization is a leading provider of insurance, annuities and employee benefit programs, serving 90 million customers on a global basis. MetLife holds leading market positions in the United States (where it is the largest life insurer based on insurance in force), Japan, Latin America, Asia, Europe and the Middle East. MetLife, Inc. is a public company with securities listed on the New York Stock Exchange and registered under the United States Securities Act of 1934.

The MetLife insurance companies are licensed and regulated in the jurisdictions where they are domiciled and conduct business. Such regulations govern the business conduct and financial aspects of the insurance business, including standards of solvency, statutory reserves, reinsurance and capital adequacy.

MetLife believes that the margin requirements as set forth in the Proposal will impede the operational efficiency of the TBA Market thereby negatively impacting market liquidity for these transactions, increasing the costs to invest in the TBA Market, and ultimately having a chilling effect on the consumer mortgage market. We respectfully ask that FINRA consider the suggestions set forth below.

Costs to Collateralize Short Duration Settlements Exceed the Risk Inherent in the Settlement Period.

Prior to and during the financial crisis of 2008, the TBA Market remained stable and liquid without the support of collateral securing the settlement of these transactions. FINRA, following the lead of the Treasury Markets Practice Group ("TMPG"), is proposing that collateral be pledged for: (i) TBA and specified pool transactions with settlement dates that extend beyond one business day, and (ii) collateralized mortgage obligation ("CMO") transactions with settlement dates of greater than three business days. The posting of collateral for transactions that essentially carry the risk of "spot trades" create operational inefficiencies and increased costs for dealers and institutional investors alike.

There are substantial costs in operating and maintaining a collateral management infrastructure to accommodate the short settlement periods required under the Proposal. Monitoring, allocating and transferring collateral to cover short dated settlements create operational burdens and expenses that far outweigh the risk inherent in settlement periods with duration of less than three days. Moreover, the requirements of the Dodd-Frank Act have placed demands on dealers and institutional investors to develop the most efficient allocation of securities that constitute eligible collateral for derivatives transactions. The Proposal adds an additional layer of regulation that creates competing demands for eligible collateral required by financial institutions that sell or invest in these products. The pool of eligible collateral within an institution is not infinite. The opportunity costs of posting collateral to an ever-expanding range of financial products will force institutions to forgo dealing in these products and / or pass the additional costs of collateralization onto consumers. In the case of the TBA Market, collateralization of short duration settlements will likely result in decreased demand and liquidity in these markets and substantially higher borrowing costs for Americans purchasing homes. In the case of MetLife, the increased costs associated with purchasing mortgage-backed securities ("MBS") to match insurance and annuity obligations will increase the costs of these products as well.

MetLife recognizes that default risk increases as settlement periods are extended. However, we believe that such risks must be balanced against the costs and negative impact on the markets that are affected. Accordingly, MetLife suggests that FINRA amend the Proposal to cover only forward-settling TBA transactions whose settlement dates extend beyond the first standard settlement date set by the Securities Industry and Financial Markets Association ("SIFMA") following the trade date for such transaction. For example, if a party executes a TBA transaction with a trade date of April 1, 2014, and the next settlement date set by SIFMA for the securities underlying such transaction is April 10, 2014, then no margin would be required in respect of such transaction. Any transactions executed on April 1, 2014 with a scheduled settlement date set by SIFMA that falls beyond the April 10, 2014 settlement date would, however, be subject to the margin requirements of the Proposal.

Margin Delivery Periods and Transaction Close Outs for the Failure to Deliver Margin Should be at the Discretion of the Parties.

Under the Proposal, any exposure deficiencies not collateralized within five business days would require an immediate "liquidating action." MetLife objects to the mandatory five day close out period for the failure to deliver margin set forth in the Proposal. TBA transactions will be governed by the SIFMA Master Securities Forward Transaction Agreement ("MSFTA") in compliance with the TMPG's best practice guidelines for the execution of TBA transactions. The MSFTA sets forth certain events of default ("Events of Default"), which include the failure of a party to deliver collateral when required; and further allows for the parties to agree on a cure period to remedy any such failure. MetLife believes that the declaration of an Event of Default should remain the province of the parties based upon terms negotiated in the MSFTA, the non-defaulting party's assessment of prevailing circumstances surrounding such default, the credit worthiness of the counterparty to the transaction, and current market conditions.

The Proposal further provides that maintenance margin and exposure deficiencies must be collateralized within one business day of the creation of such exposure. MetLife objects to this abbreviated margin delivery period as it is inconsistent with generally established collateral delivery periods of two to three business days that exist in the derivatives and other similar markets. Requiring such an abbreviated margin delivery period will require dealers and investors to modify existing collateral delivery systems and procedures. Modifications to these systems and procedures will be a time consuming and costly process.

MetLife believes that each of these changes suggested in the Proposal will have the unintended consequences of increasing the costs associated with executing TBA transactions and will ultimately reduce the liquidity in the MBS market. Accordingly, we suggest that FINRA omit the mandatory five day liquidation period set forth in the Proposal, and continue to allow the parties to maintain the flexibility to determine appropriate close out and cure periods as provided for in the MSFTA. We further suggest that FINRA allow the parties to negotiate maintenance and variation margin delivery periods that are consistent with standard market conventions.

Conclusion

MetLife would like to reiterate our appreciation for the efforts that FINRA expended in attempting to create a more resilient TBA Market. We are pleased to be able to continue to participate through the comment process and respectfully submit that certain aspects discussed above have the potential to unintentionally reduce market liquidity, increase costs in the MBS markets and unnecessarily increase the financing costs for home-buying Americans.

Respectfully,

Jason Valentino
Director

Kevin Budd
Associate General Counsel

March 28, 2014

In response to the request for comments in Regulatory Notice 14-02 regarding amendments to FINRA Rule 4210 and proposed TBA markets margins requirements:

Thank you for the opportunity to comment on the proposed amendments to FINRA Rule 4210. We understand what FINRA is trying to accomplish, however, we feel the proposed regulations create more issues than it solves for the MBS markets

The proposed changes to margin requirements, treatment of net capital and the tracking and pricing of unsettled bonds daily will create an extreme hardship to small net capital firms like ours.

The proposed changes are of great concern to us and threaten the existence of firms like ours. These changes will prevent us from participating in the MBS markets. The result of adoption of these regulations would be a reduction in liquidity of the MBS markets due to scaled down participation or complete market exit by small broker/dealers. Mid and small sized broker/dealers would be inordinately negatively impacted by the additional costs and capital commitments. In addition, features of the proposed changes could result in unbalanced margining leading to increased capital charges and increased counterparty credit risk.

A few of the areas that concern us the most are:

* The 5% limit per client and the 25% overall limit will prevent small net capital firms from participating in the MBS market.

* The cost of compliance will be excessive for small firms – adding "margin" personnel and the tracking of daily market value of unsettled trades. The administrative resources required to establish risk limits per counterparty, tracking margin calls, recordkeeping requirements to insure proper treatment of net capital and documentation requirements to insure all counterparties have like agreements in place. These tasks are excessive and burdensome. This will likely drive small net capital firms away from participating in the MBA markets-reducing liquidity. In addition, smaller investors will need to be available for counterparty credit officers from multiple broker/dealers and would be forced into adding staff with related costs or reducing the number of broker/dealer relationships.

* Unbalanced margin call threshold levels add to counterparty and MBS market risk. Receiving a margin call from our brokerage side counterparty and not being able to pass on to a number of clients counterparties because the de minimis transfer amount has not been reached.

* The potential capital charge required during the margin collection process will prevent us from using that capital to participate in our underwriting business.

*Managing the margin process for sub accounts of investment advisors. This could open our margin call process to hundreds of additional sub accounts of some of the large investment advisors counterparties. Many of our investment advisor accounts, because of privacy issues, are not transparent with the broker/dealer in terms of client's names and contact information which would make it impossible for us to pass on the margin call to the sub accounts of the investment advisor.

Most of the concerns expressed here are because of the effect on us as a firm; however, we feel the proposed changes are not necessary. The MBS markets function very efficiently now.

We don't see the need for such radical changes to the MBS market. The MBS market has functioned very efficiently throughout the extreme turmoil in the markets over the past few years. Our firm has never had a problem relating to settling a MBS trade.

Perhaps FINRA could establish a threshold on the size of open positions before the rules apply. This would relieve smaller firms, yet put in place sufficient protection to the MBS market in times of stress.

Thank you for providing us the opportunity to comment on this important rules change proposal.

Respectfully,

Doyle L Holmes
President
Mischler Financial Group, Inc.
CRD 37818

MBa

MORTGAGE BANKERS ASSOCIATION

March 28, 2014

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

Re: Regulatory Notice 14-02 – Proposed Amendments to FINRA Rule 4210 for Transactions in the TBA Market

Dear Ms. Asquith:

On January 27, 2014, the Financial Industry Regulatory Authority (FINRA) published for comment proposed changes to its rules governing margin requirements on transactions in the To Be Announced (TBA) market (the Proposal). Specifically, the Proposal would require broker-dealers to impose margin requirements on their counterparties and force the liquidation of positions in the event that counterparties do not exchange margin within five days of incurring an exposure. The Proposal would apply to TBA transactions as well as certain forward-settling transactions in specified pools and collateralized mortgage obligations.[1] The Mortgage Bankers Association[2] (MBA) appreciates the opportunity to comment on the Proposal's impact on borrowers and the broader housing market.

At the outset, MBA thanks FINRA for formalizing mortgage bankers' status as exempt accounts, and thus removing the initial margin requirement. Mortgage bankers utilize TBAs almost exclusively as a mechanism to hedge risks associated with originating loans eligible for TBA securities. As the "creators" of the assets underlying TBA-eligible securities, mortgage bankers present a vastly different counterparty profile from other participants in the TBA market. With this in mind, MBA believes the Proposal should be revised to recognize this unique relationship between mortgage banker and the TBA market generally. FINRA should exempt verified hedge positions from the Proposal's variation margin requirements.

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[1] FINRA Regulatory Notice 14-02

[2] The Mortgage Bankers Association (MBA) is the national association representing the real estate finance industry, an industry that employs more than 280,000 people in virtually every community in the country. Headquartered in Washington, D.C., the association works to ensure the continued strength of the nation's residential and commercial real estate markets; to expand homeownership and extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters professional excellence among real estate finance employees through a wide range of educational programs and a variety of publications. Its membership of over 2,200 companies includes all elements of real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, REITs, Wall Street conduits, life insurance companies and others in the mortgage lending field. For additional information, visit MBA's Web site: www.mortgagebankers.org.

If an exemption is not granted, MBA recommends FINRA impose a threshold of 2% of total position size for mortgage bankers who engage in hedge transactions. MBA also recommends that the minimum transfer amount be subject to negotiation between the parties, in recognition of the robust risk management practices currently used by broker-dealers when trading with mortgage bankers.

BACKGROUND

Mortgage bankers provide mortgage applicants with the ability to lock-in an interest rate on their mortgage loan while the mortgage bank underwrites and processes the loan application. This process allows consumers to secure a rate that will be used to underwrite their mortgage application, ensuring that if market rates increase the the lender will still be able to close the loan at the rate for which the borrower was initially qualified. If this "rate lock" is not hedged, originators would be at risk of closing a loan that is "underwater" from a market standpoint if rates rise. Therefore, originators enter into TBA trades to both mitigate this interest-rate risk and to provide the benefit of certainty to the consumer.

Mortgage bankers generally enter into forward TBA contracts whereby the originator agrees to deliver the loans expected to close into a future Ginnie Mae, Fannie Mae or Freddie Mac mortgage-backed security (MBS) at a specified price, to be settled generally within 30-90 days from the date the TBA is entered into. This process creates a hedge for the mortgage banker which puts the originator into a "risk neutral" position that preserves the revenue margin needed to cover the bank's loan origination and operating expenses, plus the target return on capital. Once the loan is closed, the originator continues using those same forward TBA contracts to hedge the loans held for sale until the pool is created and the TBA is settled.

As a matter of course, many if not most mortgage bankers provide their broker-dealers with access to the information necessary to ensure that the mortgage bankers are sufficiently capitalized and are using the TBAs to prudently hedge their exposures rather than speculate. This information is ordinarily exchanged both at the time a trading relationship is established and on an on-going basis to ensure there have not been material changes in the strength of the counterparty. Additionally, as the trading relationship develops, the broker-dealer begins to gain an intimate understanding of the flow of their counterparties' business – allowing the broker-dealer to spot behavior that is out of the ordinary.

The financial system benefits from TBA trades because the ability to reliably hedge interest rate risk allows for a diverse, competitive market of mortgage bankers to efficiently access the secondary market and operate nationwide, including in rural and underserved areas. This competitive landscape significantly reduces the concentration of risk which threatens other areas of the financial system.

Indeed, it is important to note that despite the failure of individual mortgage bankers, the broader TBA market remained active through the worst financial crisis since the Great Depression. Moreover, counterparties such as broker-dealers subject mortgage bankers of all sizes to rigorous credit and capital checks before initiating a counterparty relationship and will extend or contract credit lines accordingly.

MBA's COMMENTS

Agency TBA Securities

MBA strongly recommends that FINRA exempt mortgage bankers' hedge transactions from the final rule, thus allowing broker-dealers and mortgage bankers themselves to manage this critical risk management tool. The summer of 2013 saw substantial interest rate volatility, with rates rising then abruptly falling, before rising again for much of the remainder of the year. Despite this significant volatility, mortgage bankers remained sound TBA counterparties, and the market continued to function unimpeded. This is a testament to risk management practices that are prevalent among broker-dealers who offer trading lines to mortgage bankers.

It should be noted that the Proposal takes away from broker-dealers the ability to manage counterparty credit risk through their balance sheet and the bid-ask spread. Instead, the Proposal all but dictates the terms under which a broker-dealer's counterparty (but not the broker-dealer itself) must post margin. The Proposal does this in a "one-size fits all" manner that will make pipeline and inventory hedging more expensive for mortgage lenders and ultimately consumers.[3] Moreover, the Proposal will confer a sizable competitive advantage to Fannie Mae and Freddie Mac at the same time policy-makers are indicating a desire to reduce the GSEs' footprint in the secondary mortgage market. All of this will reduce borrower's access to housing finance capital, while concentrating the TBA market among the nation's largest financial institutions and speculative traders.

Borrowers Will Have Less Access to Credit

Put simply, the Proposal will harm borrowers by limiting their access to credit. Mortgage bankers who hedge their locked loan pipeline and warehouse of mortgages sell their loans predominantly on a mandatory execution basis. Mandatory execution means that the mortgage banker takes the risk that they will be able to deliver the agreed upon quantity of loans by a certain date. The alternative is best efforts execution, whereby the investor assumes the risk of a mortgage banker's failure to deliver the agreed upon volume of loans.

Not surprisingly, mortgage bankers who are able to utilize mandatory execution are compensated for this risk through better pricing for their loans, which translates into

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[3] This cost will be felt by larger lenders as well because the size of their positions will increase the frequency with which they would be required to exchange margin under the Proposal – driving up the operational and compliance costs even further.

more competitive rates for borrowers.[4] MBA members have indicated that this premium ranges from 18 to 50 basis points relative to the size of the loan in the current market, imposing a significant opportunity cost on best efforts execution.

Additionally, best efforts execution relies more heavily on aggregators as the investors in the loan, who often require loans to exceed the minimum credit requirements imposed by the Fannie Mae or Freddie Mac (the GSEs). These additional requirements, called credit overlays, effectively make it harder for a consumer to qualify for a loan. For example, many aggregators will not purchase a loan with a credit score below 640 or will impose additional cash reserve requirements on borrowers for loans approaching or exceeding this limit, regardless of compensating factors. Some aggregators also refuse to purchase mortgages made to finance the purchase of a condo. Each of these overlays impose a limit on some borrowers' ability to obtain competitively priced loans.

Mortgage Capital Will Become More Expensive if the Proposal is Not Amended

Moreover, implementing margin monitoring and posting systems represents a significant cost for many mortgage bankers. This cost includes not only the cash to support any margin calls, but also wire transfer, processing, and operational costs. Under the Proposal, these additional costs would need to be recouped through higher interest rates charged to consumers – either to pay for the additional overhead or to compensate for the lower return on best efforts execution.

The expense of establishing the controls and procedures to comply with the Proposal may, in many cases, exceed the value of the counterparty risk against which the margin is intended to protect. These costs will be a dead-weight loss for the duration of the trade and would likely contribute to further consolidation in the mortgage banking industry as companies find themselves too small to comply. Some originators may even be driven to the less profitable best efforts execution, resulting in a significant competitive disadvantage. In fact, these costs could become large enough to drive the mortgage banking industry to consolidate further. Originators may withdraw from certain markets or merge with other companies, limiting consumer choice. This issue is particularly acute for rural and underserved areas where access to credit is limited.

The Proposal's Terms Will Harm Competition

Recently, primary dealers began implementing the Treasury Market Practices Group's (TMPG) recommendation that market participants exchange variation margin while waiting for their TBA transactions to settle.[5] While FINRA's Proposal operationalizes much of TMPG's recommendation, it discards a core theme underlying the

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[4] As a rule of thumb, the pricing needs to be about a quarter of a point better per loan in order for mandatory execution to be worthwhile. Each point in price is worth about 25 basis points in interest rate paid by a borrower.
[5] *See* TMPG, *Best Practices for Treasury, Agency Debt, and Agency Mortgage-Backed Securities Markets, revised* May 2013 (available at: www.newyorkfed.org/tmpg) (emphasis added).

recommendation. The TMPG relied on standard market practices to guide the final terms of each trading relationship, allowing market participants the flexibility necessary (within reason) to meet their own capital needs as well as those of their counterparties.

The Proposal, however, allows no such flexibility. Parties trading TBAs with a broker-dealer, whether as part of a hedging strategy or speculation, would be required to post margin once the exposure exceeds the Proposal's minimum transfer amount of $250,000 – regardless of the size of the position. Broker-dealers, on the other hand, must take a regulatory capital charge for the entire unmargined exposure, leaving no opportunity for the parties to negotiate.

It is important to note that most, if not all, Master Securities Forward Transaction Agreements (MSFTA) to which mortgage bankers are a party require margin to be posted under certain circumstances. The parties themselves negotiate the terms of these agreements, and take into account counterparty credit strength, the experience of the management team of the mortgage banker, and the length and experience of the relationship between the mortgage banker and the broker-dealer. In many cases, the broker-dealer will require audited financial statements, pipeline reports and, in some cases, the use of a third-party hedge advisory firm to ensure that the trading line is being used prudently.

One of the Proposal's unintended consequences will be the further expansion of Fannie Mae's footprint in the secondary mortgage market. Fannie Mae's cash window provides competitive funding terms that are in many cases superior to other best efforts execution channels in either price, funding speed, or both.[6] Moreover, Fannie Mae's capital markets desk is not subject to FINRA regulations. While Fannie Mae has indicated that it will follow TMPG's recommendation, it has set its margin threshold at $3,000,000, with a $50,000 minimum transfer amount.[7] These terms dwarf what the Proposal would allow a FINRA-regulated broker-dealer to offer even its safest counterparty. At a time when comprehensive reform of Fannie Mae and Freddie Mac is a top priority of both Congress and the Obama Administration, FINRA should not promulgate rules which hamper the private market's ability to compete in the secondary mortgage market.

Agency Multifamily Mortgage-Backed Securities

MBA is concerned that the inclusion of the Multifamily Agency Mortgage-Backed Securities (Agency MF MBS) in the Proposal would have unwarranted and detrimental consequences for the Agency MF MBS market.

Background

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[6] Fannie Mae's cash window promises to fund the loan as soon as two business days after delivery. *See* Selling Whole Loans to Fannie Mae at 43 (available at: https://www.fanniemae.com/content/job_aid/selling-whole-loans.pdf)

[7] Fannie Mae, *Selling Guide* Announcement SEL-2013-10 (December 19, 2013).

Agency MF MBS typically involve loans secured by either multifamily or healthcare loans. These include residential property that contains five or more dwelling units, including apartment buildings, residential facilities for seniors or disabled persons (such as independent living, assisted living, skilled nursing facilities, memory care, and similar facilities on the healthcare loan spectrum), cooperative housing projects, manufactured housing communities, student housing, rural housing, military housing, and hospitals.[8]

Agency MF MBS are a type of securitized product for which the timely payment of principal and interest is guaranteed by an Agency or a GSE, where the Agency MF MBS represents an ownership interest in one or more multifamily housing or healthcare loans. Agency MF MBS are issued in conformity with a program of an Agency as defined in 6710 - Definitions of FINRA Rule 6700 - Trade Reporting and Compliance Engine (TRACE), where Agency is defined in paragraphs (k) and (p)[9] and Government-Sponsored Enterprise (GSE) is defined in paragraph (n).[10]

As drafted, the Proposal applies to Covered Agency Securities, which include CMOs, and it may appear that Agency MF MBS are included in the definition of CMOs by reference to endnote 13, where it states, "includes a real estate mortgage investment conduit (REMIC) and an Agency-Backed Commercial Mortgage Backed Security as defined in FINRA Rule 6710(ee)."[11] It should be noted that the definition in 6710(ee) was deleted by Amendment 1 to the Rule change proposed in SR-FINRA-2013-046.[12]

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[8] Hospitals are part of Agency MF MBS because Ginnie Mae securitizes FHA insured Multifamily Housing and Healthcare loans.

[9] (k) "Agency" means a U.S. "executive agency" as defined in 5 U.S.C. 105 that is authorized to issue debt directly or through a related entity, such as a government corporation, or to guarantee the repayment of principal and/or interest of a debt security issued by another entity. The term excludes the U.S. Department of the Treasury ("Treasury") in the exercise of its authority to issue U.S. Treasury Securities as defined in paragraph (p). (p) "U.S. Treasury Security" means a security issued by the U.S. Department of the Treasury to fund the operations of the federal government or to retire such outstanding securities.

[10] (n) "Government-Sponsored Enterprise" ("GSE") has the same meaning as defined in 2 U.S.C. 622(8).

[11] In proposed FINRA Rule 6710(ee), Agency-Backed Commercial Mortgage-Backed Security is defined as: a type of Securitized Product that is classified as a Collateralized Mortgage Obligation for purposes of the Rule 6700 Series and Rule 7730 and is issued in conformity with a program of an Agency as defined in paragraph (k) or a Government-Sponsored Enterprise ("GSE") as defined in paragraph (n), for which the timely payment of principal and interest is guaranteed by the Agency or GSE, representing ownership interest in a pool (or pools) of mortgage loans on commercial property.

[12] In addition, FINRA proposes to clarify the definition of Collateralized Mortgage Obligation ("CMO") in proposed FINRA Rule 6710(dd) to mean: "a type of Securitized Product backed by Agency Pass-Through Mortgage-Backed Securities as defined in paragraph (v), mortgage loans, certificates backed by project loans or construction loans, other types of mortgage-backed securities or assets derivative of mortgage-backed securities, structured in multiple classes or tranches with each class or tranche entitled to receive distributions of principal and/or interest according to the requirements adopted for the specific class or tranche, and includes a real estate mortgage investment conduit ("REMIC")."

The proposed revised definition of CMO makes minor technical changes and eliminates the reference to "Agency-Backed Commercial Mortgage-Backed Security." FINRA originally proposed to include Agency-Backed Commercial Mortgage-Backed Security as a type of CMO as a way to provide additional clarity for classification purposes. In light of the elimination of a Non-Agency-Backed Commercial Mortgage-Backed Security from classification as an Asset-Backed Security above, FINRA proposes to streamline the definition.

Agency MF MBS typically involve periods between the trade date and the contractual settlement date of greater than three business days, and they are subject to the following market practices:

- **Interest Rates are Locked In** - Commercial mortgage bankers (Seller) sell Agency MF MBS to institutional investors and broker-dealers to lock in interest rates to the borrower while the underlying mortgage loan is being processed, closed and funded and prior to the time that the Agency MF MBS is issued.
- **Mortgage Loan is Known at Time of the Trade** - The trade is project specific where the terms of the security and the related mortgage loan, as well as the identity of the project collateral are known at the time of trade (typically with +/- 5% loan amount variance).
- **Document Signed by Both Parties with Specific Terms** - The Agency MF MBS trade is documented through a Trade Confirmation Letter (not by a SIFMA Master Securities Forward Transaction Agreement) that is signed by both parties upon execution of the trade. The Trade Confirmation Letter specifies the terms of the underlying mortgage loan and identifies the security. It also includes specified terms for purchase price, good faith deposit, delivery, extensions, settlement, and other miscellaneous representations and warranties.
- **Trade is Ex-clearing** - The trade is ex-clearing, meaning it is not cleared through a registered clearing agency (i.e., FICC).
- **Security is Delivered to Investor** - The security is issued in book-entry form using the book-entry system of the U.S. Federal Reserve Banks and delivered to the investor delivery versus payment.
- **Good Faith Deposit Collected by the Seller** - A good faith deposit is collected by the Seller from the borrower to ensure the borrower closes the mortgage loan and is either retained or passed to the investor until such time that the security is delivered. The good faith deposit is typically 0.50 percent to 1.00 percent of the security amount and, in many cases, represents liquidated damages payable to the investor in the event that the Seller fails to deliver the security if the mortgage loan is not closed due to circumstances beyond the Seller's control or there has been a material change involving Fannie Mae, Freddie Mac, or Ginnie Mae or the rules and regulation related to the relevant Agency MF MBS such that the security cannot be issued and delivered.
- **No Interest Rate Risk** - Due to the forward sale of the project specific loan at the time of rate lock, the Seller is not taking interest rate risk or mark-to-market risk from the time of rate lock until the time the security is delivered to the investor.

The above definitional amendments eliminate the need for the defined terms "Agency-Backed Commercial Mortgage-Backed Security" and "Non-Agency-Backed Commercial Mortgage-Backed Security" since these securities would not be subject to dissemination. FINRA may propose new definitions for such securities at such time as they may be proposed to be disseminated in the future. Finally, FINRA proposes to amend FINRA Rule 6750 to clarify that Asset-Backed Securities, as proposed to be redefined, would be subject to dissemination.

- **Trade is Specific to the Mortgage** - There is not a market mechanism to replace the security as a result of a failed trade as the trade is for a specific security backed by an identified mortgage loan.

As is clear from the foregoing, the risks that the Proposal seeks to address are not evident in Agency MF MBS transactions. Consequently, it is neither necessary nor advisable to apply the Proposal's margin requirements to Agency MF MBS. As proposed, the margin requirement will almost certainly have a negative impact on Agency MF MBS market participants due to the posting of additional margin for the mark-to-market requirement, which would require significant additional liquidity on the part of market participants. This need for increased liquidity would result in a higher cost of capital for lenders, and therefore increase pricing of Multifamily and Healthcare Loans to borrowers.

Consequently, we strongly recommend that the definition of Agency MF MBS be added to the FINRA Rule 6700 definitions to clarify reporting and dissemination requirements for TRACE and to explicitly exclude these securities from the margin requirements in the Proposal.

CONCLUSION

Mortgage bankers provide critical services to communities throughout the country, and smaller lenders are particularly important in those areas left underserved by the broader market. The TBA trade remains unparalleled in its ability to allow mortgage bankers of all sizes to access the secondary market on competitive terms, allowing these entities to develop innovative ways to best serve their community's borrowers. FINRA's Proposal would reduce both competition among lenders and affordable access to credit for consumers, and may merely replace a broadly distributed risk with one more concentrated among larger participants – including an even larger presence for Fannie Mae and Freddie Mac.

FINRA's Proposal will also unnecessarily increase costs to Agency MF MBS issuers who already have extensive market conventions in place to guard against counterparty risk.

MBA appreciates the opportunity to comment on the Proposal. Any questions should be directed to Dan McPheeters at (202) 557-2780 or dmcpheeters@mortgagebankers.org; or Eileen Grey at (202) 557-2747, or egrey@mortgagebankers.org.

Sincerely,

David H. Stevens
President and Chief Executive Officer

MOUNTAINVIEW
SECURITIES, LLC

March 28, 2014

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

RE: Regulatory Notice 14-02

Dear Ms. Asquith,

MountainView Securities, LLC (the "Firm") is an introducing broker and is fully-disclosed through its clearing firm, and is subject to the collateral requirements of the Fixed Income Clearing Corporation (FICC) for itself and the entities on behalf of which we place trades. The Firm assists mortgage bankers, both depository and non-depository, in trading to-be-announced ("TBA") securities for the purpose of hedging their mortgage pipelines. Thank you for the opportunity to comment on the proposed amendment to FINRA Rule 4210.

As noted above, the Firm places TBA trades on behalf of mortgage bankers. These mortgage bankers are utilizing the TBA market as a hedge tool to manage the interest rate risk associated with committed consumer mortgage loans during the loan origination process. Our primary concerns with FINRA Rule 4210 are that the Rule (i) create uniformity and clarity in TBA collateral requirements including amount and timing, with respect to all interested parties (including the FICC, clearing firms, FINRA, etc.); (ii) establish margin requirements at levels that are reasonable in relation to market exposures; and (iii) allow market participants to continue to utilize the TBA market for hedging purposes in a cost effective manner.

Although perhaps not of immediate concern to FINRA, increased costs of hedging will obviously have an immediate and direct impact on the cost and availability of funds for home mortgages and we believe this should be given due consideration. In this regard, it is important that FINRA preserve the ability of smaller mortgage bankers to participate in TBA hedging activities. To the extent these mortgage bankers are forced to hedge their mortgage pipelines using methods that are more expensive than TBA hedging, such as mandatory or best efforts whole loan execution, these costs will likely be passed on to the consumers most likely in the form of higher interest rates.

Standardizing a TBA margin system across all regulatory and other interested parties (the FICC, clearing members, FINRA, etc.) will provide much needed transparency for the mortgage banker. Without clear and consistent guidelines surrounding collateral requirements, mortgage bankers are unable to plan their cash flow needs and adequately understand the true costs associated with hedge activities. At present, firms clearing through FICC are subject to the FICC's collateral requirements which in many cases are set as a percentage of mark to market and established on a case by case basis. Under the proposed Rule as we understand it, transactions that are cleared through a registered clearing agency, and subject to the margin requirements of that clearing agency, will not be subject to the FINRA margin requirements. We believe it is important that the FINRA Rule establishes the compliance requirements that must be met for all market participants regardless of the settlement platform. Accordingly, we do not support a two tiered system, one of which is not transparent and we believe varies from participant to participant (e.g. FICC) and the other which is fully disclosed and consistently applied (FINRA). Accordingly, we believe that the FINRA requirements, once adopted should establish the market standard for TBA margin.

With respect to margin levels and timing, these must be set in reference to the associated market exposures and the attendant increase in hedging costs. Under the proposed Rule as we understand it, there will be no initial or maintenance margin requirements for mortgage bankers that qualify as 'exempt accounts' by virtue of their hedging activities. However, as noted above, FICC may independently impose both initial margin requirements (as high as 2.5% of TBA market value or higher) and variation margin requirements (100% of any mark to market) which thereby effectively removes the benefits of the Rule's exemption for smaller mortgage bankers. This will put smaller mortgage bankers at a distinct competitive disadvantage to larger mortgage bankers who may be able to negotiate more favorable (or no) initial margin requirements even though both smaller and larger entities are hedging the same interest rate risk.

We believe that to the extent smaller firms such as ours are no longer able to provide hedging execution at competitive levels, the exit of these smaller firms from the TBA market will have a significant adverse impact on the mortgage banking business and in particular, the small to mid-sized originators. Accordingly, to the extent that Rule 4210 becomes the exclusive standard for margin and the FICC is no longer in a position to arbitrarily set these requirements, we recognize that some reasonable level of initial margin (e.g. 1% of TBA market value may be necessary and would support that in order for a level playing field for market participants. As a related concept, we believe that the de minimis requirement for the margin calls should also be consistent across the market. Although FINRA has proposed a $250,000 de minimis requirement, it may be that as a compromise taking into account FICC collateral requirements (and the collateral requirements of other market participants) the de minimis requirement may perhaps be appropriately set at a number closer to $100,000 in order to promote uniformity.

Thank you for the opportunity to comment on the proposed rule change.

Sincerely,

MountainView Securities, LLC

Pershing®

March 27, 2014

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

Dear Marcia:

Pershing LLC ("Pershing") appreciates the opportunity to comment on the proposed amendments to FINRA Rule 4210 published in Notice 14-02.

What types of market participants will be impacted by these proposals?

Generally traditional TBA transactions are for and with brokers, banks and other institutional type customers, however other covered securities e.g. mortgage backed pool transactions are sold to retail customers and may be done on an extended settlement basis to coincide with the pool factor changes. These proposals may impact these customers. New Issue CMO transactions which usually settle once a month should be exempt from this rule since they cannot be settled until the underlying issues are purchased and packaged to complete the issue.

Will liquidity negatively impact this market?

Yes, we believe that small and mid size participants will be impacted especially on the other covered securities transactions besides the traditional TBA market.

Operational costs

There will be significant development costs for new reports and tools to help our Introducing Brokers (IBs) comply with these changes as well ongoing costs for us and our IBs to monitor the reports, communicate to counterparties and deliver and receive funds. We will also have costs to enhance our reserve formula system to recognize funds received that can be used to cover unsettled losses and not be locked up. We also have to develop a new account type to recognize debits in an account that will reflect payments to a counterparty that is covered by a receivable from that counterparty and not an unsecured debt. Our plan is to have each IB open a new account in their range of accounts for each streetside broker they trade with and use that account to pay and receive collateral to cover the mark to market exposure. This is a major change to our process. We are still evaluating the costs and will follow up with that information as soon as possible.

We do not object to requiring maintenance margin for non exempt accounts (or for exempt accounts other than brokers) for traditional TBA transactions and for other covered securities that settle after the standard settlement for the product as the TMPG as stated with the exception for New Issue CMO trades as mentioned above.

Transactions with Mortgage Bankers that may exceed the amount necessary to hedge the mortgage pipeline will be very difficult to police for our IBs on an ongoing basis and impossible for a carrying firm to recognize. We recommend this provision be clarified that a broker or an IB can make this assessment on an annual basis when they review the credit quality of the mortgage banker and set the limit.

We recommend that only cash and exempt securities be accepted as collateral for margin calls on these transactions.

The close out provision on specified pool or CMO transaction on one side of the trade would be disruptive to the other side of the trade that was not in breach since these are unique issues and cannot be easily replaced with another issue.

Also if an extension of time will be permitted, will FINRA issue guidance on what will be deemed to be a valid reason for an extension with codes similar to the current extension process? We will need clarification on the tracking of the call over the 5 day period (e.g. what is expected if a counterparty is on call one day and has other transactions the next day or the market changes in its favor the next day). Will there be guidelines on how to handle these events over the 5 day period?

We recommend capital charges apply after the 5th day instead of day 1. This is consistent with other provisions of the rule.

Risk limit determination and monitoring should be the responsibility of the broker that introduces the account to a carrying firm, the IB.

A 6 month effective date could be reasonable, however we reserve the right to request an extension as we determine system enhancements to solve these issues.

What is expected if covered transaction goes beyond the settlement date and is now a fail to deliver or a fail to receive? Will the mark to market process cease and funds be returned?

We greatly appreciate the opportunity that we have been afforded to submit this letter. As always, Pershing looks forward to working with FINRA to achieve productive, positive results. We await your response and the chance to gain clarification on topics discussed above. Thank you again for your consideration.

Sincerely,

Thomas F. Guinan
Managing Director
Credit Risk Management

PIMCO

March 28, 2014

Submitted via Email to pubcom@finra.org
Marcia E. Asquith
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, DC 20006-1506

Re: Proposed Amendments to FINRA Rule 4210 for TBA Transactions

Dear Ms. Asquith:

Pacific Investment Management Company LLC (**"PIMCO"**) is pleased to submit this letter to the Financial Industry Regulatory Authority (**"FINRA"**) in response to FINRA's request for comment on its proposed amendments to FINRA Rule 4210, which would establish margin requirements for transactions in "Covered Agency Securities," which include transactions in the "To-Be-Announced" (**"TBA"**) market[1] (the **"Proposed Amendments"**).

PIMCO is a global investment management firm that serves an array of clients and manages retirement and other assets for millions of people in the U.S. and throughout the world. Our clients include state, municipal, union and private sector pension and retirement plans, educational foundations, endowments, philanthropic and healthcare institutions, in addition to millions of individual mutual fund investors. PIMCO manages assets in a fiduciary capacity on behalf of its clients and does not invest for its own account.

PIMCO participates in numerous working groups that are submitting separate comment letters to FINRA. Since we have addressed the majority of our comments through those letters, this letter will focus on one significant omission from some of those letters that we believe FINRA should be made aware of, namely that Covered Agency Securities should be defined by reference to a uniform settlement cycle of T+3.

As you know the Treasury Market Practices Group (the **"TMPG"**) developed a set of Best Practices for Treasury, Agency Debt and Agency Mortgage-Backed Securities Markets (the **"TMPG Best Practices"**) providing guidelines for market participants in the TBA market. In addition to issuing the TMPG Best Practices, the TMPG also issued a recommendation regarding the margining of forward-settling agency mortgage-backed securities (**"agency MBS"**), which proposed requiring margin for four broad categories of agency MBS transactions, including TBA

[1] The TBA market includes transactions in adjustable rate mortgages (**"ARMs"**), Specified Pool Transactions and Collateralized Mortgage Obligations (**"CMOs"**) with forward settlement dates.

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transactions, specified pool transactions, adjustable-rate mortgage (**"ARM"**) transactions, and collateralized mortgage obligation (**"CMO"**) transactions (the **"Margining Recommendation"**).[2] The Margining Recommendation provided that margining be applied based on the type of agency MBS transaction, utilizing the existing market trading and settlement conventions for each transaction type. Accordingly, the TMPG recommended that for TBA, specified pool and ARM transactions, all trades for which the difference between trade date and contractual settlement date is greater than one business day (T+1), be subject to margining; and for CMO transactions, that all trades for which the difference between trade date and contractual settlement date is greater than three business days (T+3) be subject to margining. The Proposed Amendments similarly define Covered Agency Securities by reference to the settlement cycles set forth in the TMPG Best Practices, which results in disparate margining treatment for TBA transactions based on their customary settlement cycles. While we generally agree with the TMPG Best Practices, for the reasons set forth below, we strongly believe that this aspect of the Margining Recommendation was ill-considered and will have a significantly adverse effect on the markets.

PIMCO supports a simplified approach wherein the margining requirement is applicable to all Covered Agency Securities with settlement cycles of greater than T+3. We believe that a split among various types of transactions on the basis of length of their customary settlement cycles is an unworkable distinction and should be dropped in favor of a more uniform rule that treats TBA transactions, Specified Pool transactions and CMOs similarly. A T+3 settlement cycle is the industry standard for the vast majority of fixed income securities (including mortgage pools). Our understanding is that the TMPG applied the greater than T+1 settlement cycle to TBAs, specified pool and ARM transactions because they believed this was the normal settlement cycle for these products. This is an inaccurate understanding, and therefore we think this error needs to be corrected to accurately match the normal settlement cycles of these products. In fact, specified pools and ARM transactions normally settle on a T+3 settlement cycle. Importantly, we are concerned that this mismatch will impede the liquidity of PIMCO's clients. Either the settlement cycles that include Covered Agency Securities need to match the settlement cycles of the spot market for those securities (from greater than T+1 to greater than T+3), or the settlement cycles of the spot markets should be moved to match the settlement cycles that include Covered Agency Securities (from T+3 to T+1).

As a result a number of market participants are likely to be driven out of this investment or incentivized to transact with banks that are *not* FINRA Members, thereby causing the market to become more consolidated among fewer larger players and reducing the liquidity of the TBA market. Also, because market participants may trade packaged transactions in these asset classes, we believe it is preferable that margin requirements be symmetrical for the various legs of the packaged transaction. In stark contrast, the simplified approach we recommend does not prevent market participants from agreeing bilaterally to margin transactions that settle on a T+1 or T+2 basis and therefore will not impose any additional systems or administrative burdens or costs on Members.

PIMCO supports the aim of the Proposed Amendments to mitigate the counterparty credit risk borne by participants in the TBA market and reduce the potential for systemic risk. Broadly

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[2] Treasury Markets Practice Group, TMPG Releases Updates to Agency MBS Margining Recommendation, March 27, 2013 (*available at* www.newyorkfed.org/tmpg).

speaking, PIMCO agrees with the need to reduce counterparty exposure and has been an early adopter of numerous market practices to this end. In fact, PIMCO has documented and fully collateralized its trades significantly before the financial crisis. However, despite our strong stance on reduction of counterparty risk exposure, after having done our own internal analysis, we believe that the significant costs and possible harm to the market that is likely to result from disparate margining treatment for TBAs, Specified pool and CMO transactions significantly outweighs any possible reduction in systemic risk.

Further, while we recognize the need to have a unified approach to regulation of the TBA market and to avoid market fragmentation, we recommend that if, and to the extent that, either the TMPG or FINRA modifies the scope of inclusion of these instruments, the two organizations work together to harmonize their provisions.

PIMCO appreciates the opportunity to comment on the Proposed Amendments. Should you have any questions regarding our comments, please do not hesitate to call Bill De Leon at 949-720-7612 or Aaron Kim at 212-739-3567.

Sincerely,

Bill De Leon
Managing Director

March 28, 2014

Marcia E. Asquith
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, DC 2006-1506

Via email to pubcom@finra.org

Re: Comments on the Proposed Amendment to FINRA Rule 4210

Dear Ms. Asquith:

Thank you for the opportunity to comment on the proposed amendment to FINRA Rule 4210. Robert W. Baird & Co. Incorporated is a dually registered broker-dealer and investment advisory firm. We typically contribute our comments to FINRA on proposed rules and amendments through industry representative groups of which we are members. However, given the unwarranted scope, breath, and anticipated high implementation costs of compliance associated with the proposed amendment to Rule 4210, we thought it was necessary to provide our separate comments.

Reducing counterparty risk to individual firms and systemic risk that is present in the To Be Announced (TBA) market is a laudable goal. Nonetheless, we believe simple changes could be made to the proposed amendment to Rule 4210 that would accomplish that goal without burdening FINRA members and their clients with extraneous regulatory obligations and the associated costs.

We appreciate that the proposed amendment was informed by the recommendation issued by the Treasury Market Practices Group (TMPG) of the Federal Reserve Bank of New York. However, as we are not a primary dealer, we were not given an opportunity to contribute to the shaping of that recommendation, and, as a FINRA member we believe it is necessary for us to present our perspective on the shifting aspects of that recommendation in the form of a proposed rule and on its significantly problematic aspects. While primary dealers may be well-equipped to comply with the TMPG recommendation and the proposed amendment to FINRA Rule 4210, many FINRA members and their clients find the recommendation and proposed amendment to be unduly burdensome and disruptive to the market. Therefore, one of our suggested improvements to the proposed amendment runs counter to the TMPG recommendation, while others run counter to provisions present only in the FINRA proposed amendment.

I. Limit Covered Agency Securities

The proposed amendment mirrors the scope of the TMPG recommendation with respect to covered securities. In FINRA Notice 14-02 the subject securities are given the name Covered Agency Securities and include:

- TBA transactions for which the trade date and contractual settlement date is greater than one business day, inclusive of ARM transactions

- Specified pool transactions for which the difference between the trade date and contractual settlement date is greater than one business day
- CMOs 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

We believe the scope of the Covered Agency Securities should be changed to eliminate specified pool transactions unless the difference between the trade date and contractual settlement date is greater than three business days. The specified pool market is distinct from the TBA market in that the identity of the securities to be delivered is specified at the time of the trade, much like in other securities markets. Other types of investment securities, including equities and high-yield bonds, with regular way settlements of three business days are not subject to margining in cash accounts. We see no reason to distinguish among these investment securities, each of which presents counterparty and systemic risk.

While FINRA has indicated a desire to have the TMPG recommendations inform the proposed amendments, clearly there are points of divergence where the insertion of FINRA's expertise was deemed more important than consistency between the two. We belief this is one point where a divergence between the two is warranted.

II. Remove the Concepts of Non-Exempt Accounts and Mandatory Maintenance Margin

The proposed amendment would require that FINRA member firms differentiate between exempt and non-exempt counterparties and collect maintenance margin from non-exempt accounts. The regulatory burden on FINRA member firms to comply with this provision of the proposed amendment far outweighs any incremental benefit to accomplishing the stated goal of reducing counterparty and systemic risk.

The use of exempt and non-exempt classifications as outlined in the proposed amendment will be burdensome for firms that have not previously needed to make this determination on the subject clients. This burden will continue indefinitely as firms work to add new clients and to periodically confirm the status of existing clients. The difficulties inherent in accurately maintaining a list classifying clients according to an arbitrary cutoff when these clients have little incentive to promptly provide the requested information should not be minimized. This will require firms to devote substantial resources to this task.

The collecting of maintenance margin could also significantly increase the compliance burden on FINRA member firms, assuming of course non-exempt clients continue to be active in this market and to use FINRA member firms for these transactions. We are adding the capability to perform margining as envisioned by the proposed amendment, and due to cost considerations (set forth in detail in Section IV of this letter), we will be utilizing our firm's internal resources and a manual process. The mandatory collection of maintenance margin from non-exempt clients could potentially add to the frequency of the movement of margin and result in the need for additional personnel to comply with the proposed amendment.

There may be additional unintended consequences to this provision of the proposed amendment. We anticipate affected non-exempt clients will be reluctant to agree to a mandatory maintenance margin provision. From a client's perspective, the posting of this maintenance margin will add counterparty risk since the client's money is now exposed to the risk of default by the dealer. We could subsequently lose that business to competitors that are not members of FINRA or these clients could simply exit the market. As a result, liquidity within the market of the subject securities could be harmed.

The TMPG recommendation does not require that firms collect maintenance margin. The TMPG recommendation also does not include the concept of exempt or non-exempt accounts. Before burdening FINRA member market participants with this onerous provision it would seem reasonable for rule makers to quantify the extent of counterparty and systemic risk caused by non-exempt clients operating in the TBA market.

Even if it is the case that non-exempt counterparties are, and continue to be, active participants in the trading of Covered Agency Securities, other provisions of the proposed amendment are sufficient to address this issue. FINRA member firms will be required to perform a credit risk analysis of each counterparty, to daily mark-to-market covered transactions, and to collect variation margin when a de minimis transfer amount is exceeded. In addition, through their own risk management processes, firms may decide on their own to require maintenance margin for particular counterparties. These other provisions of the proposed amendment add several layers of protection which heretofore did not exist, and do so without overburdening the limited resources of FINRA member firms.

Finally with respect to exempt and non-exempt accounts, Supplemental Material .04 states that the determination of whether an account qualifies as an exempt account shall be made based on the beneficial owner of the account. The proposed Supplementary Materials creates enormous burdens for FINRA members that deal with money managers and other institutions that serve as agents for a large number of clients. We would like to confirm that the established principles regarding master and subaccounts, most recently addressed by FINRA in Regulatory Notice 10-18, remain unchanged. And furthermore, as noted in Regulatory Notice 10-18, where "there are legitimate business arrangements where the identities of the beneficial owners are not disclosed to the firm", that this Supplemental Material .04 does not change FINRA member firm's obligations with respect to these unidentified beneficial owners.

III. Allow Firms' Credit Risk Analysis to Determine De Minimis Transfer Amount

Within the industry, there has been adoption of the SIFMA standard Master Securities Forward Transaction Agreement (the "MSFTA"). The MSFTA is flexible in that the parties can negotiate an increased or reduced de minimis transfer amount ("Minimum Transfer Amount" per the verbiage of the MSFTA) depending on the perceived credit risk. While many MSFTAs are being put in place with a Minimum Transfer Amount of $250,000, there have been negotiations between parties to both increase and lower that Minimum Transfer Amount where it made sense to do so. We recommend that firms continue to be granted this flexibility to base their counterparty exposure levels on a credit risk analysis rather than on a one size fits all dictum that does not take into account the unique characteristics of each counterparty.

The imposition of a de minimis transfer amount of no greater than $250,000 is unnecessary in light of other provisions of the proposed amendment. Under the proposed amendment firms will be performing and documenting their credit risk analysis of counterparties. In addition, firms will be taking a capital charge for any uncollected margin amounts. Any one of these provisions of the proposed amendment by itself would significantly reduce both counterparty and systemic risk. We submit that including all three provisions together is over engineering a solution to the problem being addressed.

Instead of imposing a de minimis transfer amount, we propose allowing firms to make use of the credit risk analysis mandated by the proposed amendment to set an appropriate de minimis transfer amount on a client-by-client basis. The TMPG recommendation embraced this flexible approach and did not even include the additional requirement of a capital charge for uncollected margin amounts.

IV. In Conclusion: Simplify the Rule so Firms Can Comply in a Cost Effective Manner

As we set forth above, the goals of reducing counterparty and systemic risk can be accomplished with a simplified version of the proposed amendment. The cost of implementation and compliance with the proposed amendment would be substantially reduced by such a simplification.

When the TMPG recommendation was issued, we, like many firms without a margining department in place, began to investigate our alternatives. We quickly learned that we would be choosing from a menu of bad options. Each option was expensive and only partially resolved our issues. These options included purchasing special software to assist in margining functions, hiring a third party vendor to manage our margining responsibilities, or building this capability in-house.

The cost of purchasing specialized software to manage the bilateral margining of securities is high. We have received a quote in excess of $600,000 to purchase and implement a software system to accomplish this task. The quote also required an annual fee of approximately $100,000. Even with the specialized software we would likely need additional internal resources to run the software and initiate margin calls.

We have also investigated outsourcing the management of bilateral margining of the subject securities. Our research indicated the costs associated with this would be approximately $400,000 per year. Even with an outsourced solution there would still remain the tasks of negotiating margining agreements and communicating with affected clients to gather the requisite authority to enter into such agreements.

Because of the high costs associated with either purchasing specialized software to manage the bilateral margining process or outsourcing the process to a vendor, we are building a comprehensive in-house capability from scratch. Under the TMPG recommendation we were confident that we could build a workable process in-house. However, as the additional complexities of the FINRA proposed amendment have come to light we are extremely concerned about the difficulties inherent in complying with the proposed amendment.

By reducing the number of potentially affected securities by only including specified pool transactions with a greater than three day settlement, by eliminating the exempt/non-exempt classifications and the associated maintenance margin, and by limiting the number of margin calls between low risk counterparties using a flexible approach to setting de minimis transfer amounts the proposed amendment could be made more workable while still greatly reducing counterparty and systemic risk.

We appreciate the opportunity to comment on the proposed amendment to Rule 4210 and your consideration of our thoughts.

Sincerely,

Charles M. Weber
Managing Director and Senior Associate General Counsel
Robert W. Baird & Co. Incorporated

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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.

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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

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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

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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

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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

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March 28, 2014

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

Comment Letter: FINRA proposed amendments to FINRA Rule 4210 to establish margin requirements for transactions in the To Be Announced (TBA) market

Dear Ms. Asquith:

I. Introduction and General Comment

We are grateful for this opportunity to submit this comment letter in respect of the above-mentioned proposed amendments to FINRA's Margin Rule 4210. Following consultation with a number of members of FINRA, Shearman & Sterling LLP respectfully submits this comment letter to FINRA regarding Regulatory Notice 14-02 that provides for a number of proposed amendments to FINRA Rule 4210 to establish margin requirements for transactions in the To Be Announced (TBA) market (the "Proposal").

1.1 General comment: the burdens of the Proposal, including burdens on competition, are significant, and need to be carefully assessed

In general, the FINRA member firms with whom we consulted support the underlying goal of the Proposal to reduce risk in the TBA market. However, the members believe that the Proposal will create higher costs of trading in TBA instruments, particularly for small accounts. The firms with whom we have consulted are concerned that the benefits of the Proposal are outweighed by costs that will be incurred as a result of the Proposal, and that the impact of the Proposal on competition, and the market generally, has not been considered in sufficient detail by FINRA. We, therefore, as a preliminary matter, recommend that the Proposal, when submitted to the Commission, contain a detailed evaluation and analysis of the costs and impact on competition of the Proposal, as well as a detailed discussion of the prospective negative impact of the Proposal on this market.

1.2 Outline

With that general comment said, our comments address six basic aspects of the Proposal: (i) the required amount of maintenance margin; (ii) the treatment of sub-accounts under the Proposal; (iii) the treatment of mortgage bankers under the Proposal; (iv) the definition of exempt accounts; (v) the capital deduction under the Proposal and (vi) the effects of posting margin away.

II. Substantive comments to the Proposal

2.1 The amount of maintenance margin to be posted by non-exempt accounts, if any, should be set by the member based on the member's risk assessment of the account.

The Proposal provides that for transactions with non-exempt accounts, members must collect maintenance margin equal to 2 percent of the market value of the securities.[1] As FINRA is aware, current industry practice is that members do not collect initial margin from counterparties. We believe that altering the market drastically, to now require a pre-determined amount of initial margin, will have negative unintended consequences. For example, the 2% margin requirement may be too great for some counterparties, forcing them to exit the TBA market or otherwise transact with market participants that are not subject to FINRA regulation. Further, due to the operational burden and counterparty risk issues associated with establishing a margin relationship, counterparties may naturally be reluctant to maintain the same number of broker relationships that they now enjoy. The result of a reduction in the number of brokers used by counterparties in this market will correspondingly be a reduction of the number of brokers in this market, and, as a result, a reduction in the competitiveness of the market.

It is our view that these consequences are appropriately mitigated by one of two approaches with the same end goal of providing flexibility as to the appropriate levels for initial margin as not to overly burden counterparties and drive them out of the market or force them to limit the number of trading relationships. One view is that members be allowed to set the amount of initial margin required of non-exempt accounts, if any, based on a risk assessment of such account. In this regard, we note that the Proposal requires members to make a determination in writing of a risk limit to be applied to each counterparty.[2] This requirement, will allow members to consider the risk associated with each non-exempt account and alter the amount of initial margin accordingly. Accordingly, we recommend that members be permitted to determine the amount of initial margin required of non-exempt accounts based on their risk analysis of such account.

Another view supported by the members we represent is that FINRA, together with the Commission, or acting in concert with Commission staff, set the maintenance margin percentage , however, on a more flexible basis. One way to do this would be to provide a sliding scale for the margin maintenance percentage more correlated to risk , to assist members in determining the appropriate amount of margin to be collected. This request is consistent with FINRA Rule 4210 as it exists today.[3]

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1 Proposed FINRA Rule 4210(e)(2)(H)(ii)(e).

2 See Proposed FINRA Rule 4210(H)(ii)(b).

3 See e.g., FINRA interpretive guidance found at Rule 4210(e)(2)(F)/04.

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2.2 The treatment of Sub-Accounts under the Proposal should be consistent with existing FINRA and industry principles in respect of the recognition of Sub-Accounts.

The Proposal provides that "[f]or purposes of paragraph (e)(2)(H) of this Rule, the determination of whether an account qualifies as an exempt account[4] shall be made based upon the beneficial ownership of the account. Sub-accounts managed by an investment adviser, whereby the beneficial owner is other than the investment adviser, shall be margined individually."[5] When dealing with certain counterparties, members recognize the investment adviser as the counterparty, as opposed to the underlying sub-accounts, in accordance with FINRA principles.[6] We are of the view that members should be allowed to apply the margin requirements set forth in the Proposal at the level of the investment adviser, rather than separately to each sub-account. We are of this view for three reasons.

First, the recognition of a *bona fide* investment advisory arrangement by a broker-dealer is an ordinary-course, prudent and efficient means of conducting business as an intermediary. Absent identifying information of the kind discussed by FINRA in Regulatory Notice 10-18, a member firm usually finds that dealing with the investment adviser is sensible, efficient and prudent from a margin (and credit risk) perspective. Forcing members to separately evaluate the credit and client profiles of each Sub-Account will be both labor-intensive and inefficient, and is unlikely to give rise to additional conservatism on the part of broker-dealers.

Second, the proposal to separately margin each sub-account will require members to obtain new information regarding sub-accounts in order for the member to analyze whether the sub-account is an exempt account or not, to in turn allow the member to determine the appropriate margin requirements. For members that do not currently collect this information with respect to certain of their investment adviser counterparties' sub-accounts, requiring this

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4 An exempt account is defined under the FINRA rules as: "(A) a member, non-member broker-dealer registered as a broker or dealer under the Exchange Act, a "designated account," or (B) any person that: (i) has a net worth of at least \$45 million and financial assets of at least \$40 million . . . and (ii) either: a. has securities registered pursuant to Section 12 of the Exchange Act, has been subject to the reporting requirements of Section 13 of the Exchange Act for a period of at least 90 days and has filed all the reports required to be filed thereunder during the preceding 12 months (or such shorter period as it was required to file such reports), or b. has securities registered pursuant to the Securities Act, has been subject to the reporting requirements of Section 15(d) of the Exchange Act for a period of at least 90 days and has filed all the reports required to be filed thereunder during the preceding 12 months (or such shorter period as it was required to file such reports), or c. if such person is not subject to Section 13 or 15(d) of the Exchange Act, is a person with respect to which there is publicly available the information specified in paragraphs (a)(5)(i) through (xiv), inclusive, of SEA Rule 15c2-11, or d. furnishes information to the SEC as required by SEA Rule 12g3-2(b), or e. makes available to the member such current information regarding such person's ownership, business, operations and financial condition (including such person's current audited statement of financial condition, statement of income and statement of changes in stockholder's equity or comparable financial reports), as reasonably believed by the member to be accurate, sufficient for the purposes of performing a risk analysis in respect of such person."

5 Supplementary Material .04 of FINRA Rule 4210.

6 FINRA has summarized these principles on numerous occasions, including in Regulatory Notice 10-18 ("Master and Sub-Account Arrangements").

analysis will be onerous, and is likely to be resisted by investment advisers, who will have to furnish such information.[7]

Finally, the requirement to margin each Sub-Account individually would bring tremendous cost and inefficiency not only to the broker-dealer's compliance function, but also to the transaction process. Whereas a *bona fide* investment adviser arrangement currently permits the efficient addition of new Sub-Accounts to the trading process, the rule as proposed threatens to slow each new transaction as the parties determine the feasibility and substantive complete-ness of the proposed sub-accounting for each new transaction.

We respectfully request that the Proposal be amended to provide that where the member recognizes the investment adviser as its counterparty in accordance with FINRA principles, Sub-Accounts not be separately margined. Alternatively, we ask that FINRA substantially extend the implementation timeline to give members time to complete the time-consuming task of analyzing each Sub-Account for their purpose.

2.3 The treatment of Mortgage Bankers should recognize that information regarding the purpose of any specific counterparty's transactions is neither efficiently nor easily obtained, and would need to be frequently updated to recognize day-to-day change.

The Proposal provides that "[m]embers may treat mortgage bankers that use Covered Agency Securities <u>to hedge their pipeline of mortgage commitments</u> as exempt accounts for purposes of…this Rule."[8] (Emphasis added.) While we agree that mortgage bankers should be treated as exempt accounts, we respectively request that the condition that such mortgage banker must be hedging their pipeline of mortgage commitments be removed.

In short, we believe that knowledge and/or identification of this additional condition is unmanageable for FINRA members. Not only are the mortgage bankers' pipelines of mortgage commitments completely opaque to member firms, but such commitments are variable, changing intra-day based on factors such as the origination of new mortgages and the payment – or prepayment – of existing mortgages. Further, members are not in a good position either to diligence or to verify that specific transactions are intended to hedge mortgage commitments. Members, therefore, are not able to determine if the Covered Agency Securities[9] are being used for hedging purposes.

We also, again note that the Proposal requires that members make a determination in writing of a risk limit to be applied to each counterparty.[10] This requirement will allow members to

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7 One member with which we discussed the Proposal reported that, at the instruction of *bona fide* investment adviser counterparties, they allocate transactions to approximately 8,000 Sub-Accounts, which would each need to be analyzed in order to comply with the proposed margin requirements.

8 Proposed FINRA Rule 4210(e)(2)(H)(ii)(d).

9 Capitalized terms used, but not defined here have the meanings ascribed to them in the Proposal.

10 See Proposed FINRA Rule 4210(H)(ii)(b).

consider the risk associated with the mortgage banker's Covered Agency Securities and alter the applicable risk limits in accordance with such analysis. We, therefore, respectively request that members be permitted to treat mortgage bankers as exempt accounts with respect to all Covered Agency Securities.

2.4 The definition of exempt accounts should expressly include non-U.S. entities.

The current definition of exempt accounts only applies to U.S. based entities.[11] We ask that FINRA broaden this definition so it applies to both U.S. and non-U.S. entities that otherwise meet the definition. We believe that there is not a sufficient distinction between U.S. and non-U.S. financial industry participants to justify differential treatment under the FINRA rules.

To the extent FINRA is reluctant to expand the definition generally, then we recommend that the benefits a U.S. exempt account enjoys be expanded to like non-U.S. entities solely with respect to the Proposal. A limited expansion such as this would allow FINRA the opportunity to determine whether broader expansion of the definition is warranted, or whether such expansion poses presently-unidentified market risks.

2.5 The capital charge for uncollected margin below the minimum transfer amount should recognize members' credit risk evaluation and analysis.

The Proposal provides that "[a]ny aforementioned deficiency or mark to market losses with a single counterparty need not be collected if the aggregate amount of such deficiency or mark to market loss does not exceed $250,000 ("the minimum transfer amount"), provided the member deducts such amount in computing net capital as provided in SEA Rule 15c3-1."[12]

Imposing a dollar-for-dollar deduction for deficiencies below the minimum transfer amount is insensitive to the counterparty risk analysis undertaken by members, and onerous from a capital perspective. We believe that the deduction should be required as a percentage of mark to market value of the subject securities and correlated to the probability of default. While some members we consulted believe that this risk analysis should be determined by the member in good faith on a counterparty basis, an alternate view put forth by other members is that FINRA provide the risk assessment model.

Under the first view, members would undertake a risk review of counterparties as required by the Proposal, which review would allow the member to determine the appropriate capital deduction, as well as to negotiate an appropriate minimum transfer amount.[13] Firms' good faith counterparty risk assessments, which FINRA will have the opportunity to guide and review, should likewise permit a corresponding good faith reduction in the required deduction.

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11 See FINRA Rule 4210(a)(13).

12 FINRA Rule 4210(H)(ii)(f).

13 See Rule 4210(H)(ii)(b).

Accordingly, these members request that FINRA modify the Proposal to allow members to determine the appropriate capital deduction based on the member's risk analysis of the counterparties. In this respect, we also note that this recommendation is consistent with existing FINRA interpretive guidance found at Rule 4210(e)(2)(F)/04, which specifically addresses the importance of establishment of counterparty credit limits in this regard (and further provides additional guidance in respect of deductions from capital relating to the period to contract maturity), and is consistent with the prudent and robust counterparty risk assessment methodologies currently employed by the industry.

In the alternative view held by other members, consistent with this existing FINRA guidance and a more flexible and less onerous approach than imposition of regulatory capital on a dollar for dollar basis a standardized approach to a required regulatory capital deduction set by FINRA would be welcome. They recommend that FINRA implement a more detailed risk assessment model for members to use in determining the amount of the capital deduction. They note, however, that by requiring a dollar-for-dollar capital deduction, the draft proposal assumes a 100% probability of default, rather than utilizing market standard guidelines to determine this risk. If market standard risk based guidelines were applied, the result would be a much smaller probability of default and therefore, these members would suggest a lesser correlating percentage of regulatory capital be applied, not a dollar for dollar amount, but that these percentages be set by FINRA guidance. Further, we note that this approach would be consistent with the Basel III model.

2.6 The capital charge for uncollected margin should recognize members' credit risk evaluation and analysis in order to mitigate the effects of counterparties posting initial margin with third-party custodians.

Under the Proposal, counterparties are required to post initial margin to the member. In other markets, when posting initial margin, market participants from time to time request that instead of its broker-dealer counterparty holding any required initial margin, such participant be permitted to deposit the initial margin into an account with a third-party custodian that is pledged to the broker-dealer counterparty. While we acknowledge that there are benefits to such tri-party agreements, this arrangement would cause an undue burden on members. In implementing the tri-party arrangement, the member would in the usual course no longer be permitted to rehypothecate the initial margin collected from the counterparty. Therefore, if the member seeks to hedge a TBA transaction where the initial margin is being held by a third-party, the member will itself have to raise capital in order to post margin under the hedge transaction, instead of using the margin posted to it.[14] This will, undoubtedly, be a burden on all members, and a significant burden to competition that has not been evaluated.

Unfortunately, there are few good solutions to this problem. One way to mitigate this added burden, however, is by reducing the dollar-for-dollar deduction from capital for any

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14 This is similar to the scenario where firms may 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. As FINRA acknowledges in this context, this could cause a significant liquidity strain on all members; we believe irrespective of their size.

deficiency or mark-to-market losses, and instead allowing members to determine the appropriate capital deduction below the minimum transfer amount based on its risk analysis of its counterparties, as discussed in Section 2.5 above.[15] We, therefore, respectfully request, again, that FINRA allow members to determine the appropriate capital deduction for deficiencies, including for deficiencies below the minimum transfer amount, based on their good faith risk analysis of their counterparties. Further, we believe that a member should not be disadvantaged from a capital perspective merely because it permit its counterparty to post collateral to a third-party bank. We are therefore of the view that the amount of collateral held by a third-party custodian and subject to a control agreement in favor of a member, should be permitted to be added to the member's net capital for purposes of computing the same in accordance with Rule 15c3-1. We recognize that such a rule would require consultation with the Commission, and encourage FINRA to make such consultations part of the rulemaking in this respect.

III. Conclusion

We thank you for considering these requests in connection with the Proposal and are, of course, very happy to discuss with you in greater detail any of our comments or requests. Please do not hesitate to contact the undersigned at russell.sacks@shearman.com or 212-848-7585 if you have any questions or require further information.

Sincerely,

Russell D. Sacks
Shearman & Sterling LLP

[15] See Proposed FINRA Rule 4210(H)(ii)(b).

sifma
Invested in America

March 28, 2014

Submitted Via Email to pubcom@finra.org

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

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

Dear Ms. Asquith:

The Securities Industry and Financial Markets Association ("SIFMA")[1] submits this letter to the Financial Industry Regulatory Authority ("FINRA") in response to FINRA's request for comment on its proposed amendments to FINRA Rule 4210 to establish margin requirements for transactions in the "to-be-announced" ("TBA") market (the "Proposed Amendments"). SIFMA supports FINRA's stated aim to reduce counterparty credit risk and welcomes the opportunity to comment on the Proposed Amendments. In this comment letter, we will focus on the major impact of the Proposed Amendments, with a focus on the impact on FINRA members, while also addressing issues of clarity, operational feasibility and unintended consequences.

I. Scope of Proposed Amendments

The Proposed Amendments apply to cash and margin transactions in "Covered Agency Securities" with any counterparty, other than a central bank. FINRA has proposed to include as "Covered Agency Securities" (a) TBA transactions, as defined in FINRA Rule 6710(u), for which the difference between the trade date and the contractual settlement date is greater than one business day (including adjustable rate mortgage ("ARM") transactions), (b) "Specified Pool Transactions," as defined in

[1] SIFMA brings together the shared interest of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association. For more information, visit www.sifma.org.

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FINRA Rule 6710(x), for which the difference between the trade date and the contractual settlement date is greater than one business day (such transactions, together with TBAs, "Agency MBS" transactions), and (c) transactions in "Collateralized Mortgage Obligations" ("CMOs"), as defined in FINRA Rule 6710(dd), issued in conformity with a program of an "Agency," as defined in FINRA Rule 6710(k), or a "Government Sponsored Enterprise," as defined in FINRA Rule 6710(n), for which the difference between the trade date and contractual settlement date is greater than three business days.[2]

A. Sovereign Counterparties

Under the Proposed Amendments, transactions in Covered Agency Securities with a counterparty that is a "central bank" would not be subject to margin requirements under Rule 4210. Although the Proposed Amendments do not include a definition of "central bank," footnote 23 of Regulatory Notice 14-02 (the "RN 14-02") states that that "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." SIFMA recommends that FINRA incorporate this interpretation into Rule 4210 (or into its interpretation handbook). SIFMA further requests that FINRA also exempt (or include in the definition or interpretation of "central bank" for purposes of the Proposed Amendments) "sovereign wealth funds" guaranteed by sovereigns, where "sovereign wealth fund" is defined as "a specialized investment fund created or owned by a government to hold foreign assets for long-term purposes." SIFMA believes that sovereign wealth funds guaranteed by sovereigns present similar credit profiles to sovereign themselves and should, therefore, be similarly excluded from the scope of the Proposed Amendments.

B. Bona Fide Cash Transactions by Smaller Firms

FINRA members that are not members of the Fixed Income Clearing Corporation's Mortgage-Backed Securities Division (the "MBSD") should not be required to margin Specified Pool Transactions booked into their customer's cash accounts for T+3 (or sooner) settlement. These transactions, which are executed by smaller dealers with their customers and frequently do not even settle on the standard monthly settlement dates, are true cash account transactions and there is no more reason to margin them than any other cash account transactions. This narrow exclusion to the definition of "Covered Agency Securities" would be a significant benefit to small dealers and their customers (who would be able to continue to engage

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[2] We understand that the Proposed Amendments to Rule 4210 cover only forward settling purchase or sale transactions on agency MBS or CMOs and are not intended to affect the margin requirements for ordinary credit transactions (such as margin loans or repo transactions).

in bona fide cash transactions without major operational and documentary changes) and would also be consistent with the intent behind the definition of "Covered Agency Securities." We understand that FINRA defined "Covered Agency Securities" to correspond to the Treasury Market Practice Group's ("TMPG's") Best Practices for Treasury, Agency Debt and Agency Mortgage-Backed Securities Markets (the "TMPG Best Practices"), which recommended the exchange of two-way variation margin for Agency MBS transactions with a settlement date greater than T+1 and CMO transactions with a settlement date greater than T+3. We understand that one reason why the TMPG's recommendation had this scope is that the TMPG wanted their recommendation to cover the significant volume of T+2 and T+3 Agency MBS transactions executed at and around the time the TBA sellers notify the buyers of the pools to be delivered. The exclusion requested in this paragraph would not prevent Rule 4210 from covering the vast majority of this volume.

C. Securities Outside the Scope of the TMPG Recommendation

As presently constituted, the Proposed Amendments appear to cover TBA and specified pool transactions on certain securities (*e.g.*, pools of agency multifamily loans) that are outside the scope of the TMPG's recommendations. Scope differences between Rule 4210 and the TMPG Best Practices would be contrary to FINRA's stated design for the scope of the Proposed Amendments "to be congruent with the products covered by the TMPG best practices." They would also introduce competitive disparities between FINRA members and other agency MBS dealers, as well as increase the documentary and administrative burden on FINRA members. We therefore recommend that FINRA clarify that only pools of single-family residential mortgages (and CMOs backed by such pools) are covered by the proposed new provisions of Rule 4210.

II. Margin Requirements

A. Maintenance Margin Requirement

Under the Proposed Amendments, bilateral transactions in Covered Agency Securities would be marked to the market daily and the member firm required to collect from its counterparties any mark to market loss on such transactions. In addition, if the counterparty is not an exempt account, the member firm would be required to collect maintenance margin equal to 2% of the market value of the securities subject to the transaction.

SIFMA opposes the requirement that 2% maintenance margin be collected from non-exempt accounts. The TMPG Best Practices only recommend the exchange of variation margin; they do not recommend the collection of maintenance margin. This deviation from the Best Practices can place FINRA members at a competitive disadvantage or have an adverse impact on the market for Covered Agency Securities. Customers who are unable to meet the requirements to qualify as exempt accounts, or who are unwilling to provide the necessary information to be considered by the member firm to be exempt accounts,[3] will have a choice of posting maintenance margin to a FINRA member (with the concomitant expense and credit exposure to the FINRA member), taking their business to a bank acting as a government securities dealer, or exiting the market altogether. We believe that a significant number of investors could opt to take their business to banks (with adverse effects on their former broker-dealers) or exit the market (with adverse effects on the Agency MBS market and indirect adverse effects on the mortgage, and therefore real estate, markets). These effects may be particularly devastating to small firms, which depend to a greater extent on non-exempt account investors, and the CMO market, which has a large proportion of retail investors. Even if no investors left the market or moved to banks, the cost of maintenance margin can be expected to reduce demand for Covered Agency Securities, therefore increasing the hedging costs for mortgage originators (or reducing the value of their production), who can be expected to pass these costs on to mortgage borrowers, thereby increasing the expense of mortgages used by American families to buy their homes. Further, in order to collect the required maintenance margin from non-exempt accounts, FINRA members will face the operational burden and costs of having to implement new documentation with customers or renegotiate existing documentation.[4]

B. Calculation of Maintenance Margin on Net Position

To the extent that FINRA does decide to impose a 2% maintenance margin requirement on bilateral transactions in Covered Agency Securities by non-exempt account customers, SIFMA seeks clarification of the position on which such margin should be charged. SIFMA believes that the 2% margin should not be charged on a counterparty's gross positions, but instead on the net of all of the counterparty's positions. A counterparty's gross positions are not the best representative of the risk posed by those positions. For example, a "paired" TBA position, where the counterparty has locked in a gain or loss by buying and selling the same CUSIP, has no risk to the broker-dealer (beyond any locked-in loss) rather than twice as much risk as either of the separate legs of the paired TBA. Similarly, a broker-dealer has less risk exposure to a counterparty that sells one TBA and buys another (*e.g.*, in a "dollar roll" trade) than the broker-dealer would have to a counterparty that had just one side of the

[3] High net worth individuals are often reluctant to provide their broker-dealers with detailed financial information and, even if eligible for "exempt account" status, may choose not to provide this information. This issue is likely to be particularly acute for smaller broker-dealers who depend on this client base.

[4] FINRA members' investment manager customers will, in turn, have to go back to their clients to get permission to post margin to the FINRA member, creating further costs and delays.

transaction. For this reason, we believe that the 2% maintenance margin requirement should be calculated only on the counterparty's net position, calculated as the difference between the aggregate market value of all of the counterparty's buy positions in Covered Agency Securities and the aggregate market value of all of counterparty's sell positions in Covered Agency Securities. Further, SIFMA recommends that FINRA clarify how a firm should determine the value of the counterparty's positions in TBA transactions, given that the underlying securities do not have a concrete value outside of the TBA market (*i.e.*, should the current TBA contract price be used?).

C. Margining of Fails

SIFMA also seeks clarification that the Proposed Amendments would not require FINRA members to margin Covered Agency Securities transactions for which the selling party has failed to deliver the security by the contractual settlement date ("fails"). SIFMA notes that the margining of fails would be operationally challenging for many member firms. In fact, TMPG considered adopting a recommendation to margin fails in its Best Practices but ultimately did not recommend such margining due to the operational difficulties.[5] In recognition of the operational difficulties of margining fails, and the asymmetry between the party failing and the party being failed to, SIFMA's Master Securities Forward Transaction Agreement (the "MSFTA"), which is the agreement most commonly used to document margin requirements on Covered Agency Securities transactions, permits but does not require the collection of margin by the non-failing party; it does not permit the failing party to collect margin on the failed transaction.[6]

III. Exempt Accounts

A. Mortgage Bankers

Under the Proposed Amendments, member firms may treat "mortgage bankers" that use Covered Agency Securities to hedge their pipelines as exempt accounts, but the member firms must "adopt procedures to monitor the mortgage banker's pipeline of mortgage loan commitments to assess whether the Covered Agency Securities are being used for hedging purposes."

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[5] While TMPG does not currently recommend the margining of fails in its Best Practices, TMPG has indicated that it might re-visit the margining of fails at a future time.

[6] Although due to the complexity of the Agency MBS market, fails are still more common in that market than other markets, they have been significantly reduced by the TMPG's recommendation that, by February 2012, market participants begin imposing fails charges on the failing party. Primary Dealer Statistics from the FRBNY show an average weekly AMBS failure-to-deliver (across all coupons) for 2010 and 2011 of $447.935 billion as compared to an average of $122.066 billion in the period from February 2012 to March 27, 2013. Data available at http://www.newyorkfed.org/markets/gsds/search.html.

SIFMA believes that while firms should (and currently do) understand their mortgage banker clients' business and set limits accordingly, firms are certainly not in a position, nor do they have the access or tools required, to meaningfully monitor the trading activities of a mortgage banker with its multiple trading counterparties or whether any one transaction or a particular set of transactions are executed by a mortgage banker for hedging, commercial, speculative or any other purpose.

SIFMA would like to confirm that FINRA members may comply with this requirement by adopting reasonable procedures such as obtaining representations or a certification from mortgage bankers about the nature of their business and use of Covered Agency Securities transactions for hedging purposes, and that FINRA members have flexibility in designing such procedures. Again, a requirement that member firms monitor their mortgage banker clients is not feasible and would largely eliminate the ability of mortgage bankers to qualify as exempt counterparties. This outcome would hamper the market through which mortgage bankers hedge their origination pipelines. As mentioned earlier, increased costs in hedging the origination pipeline resulting would likely be passed on to mortgage borrowers, making it ultimately more expensive to finance home purchases.

B. Non-U.S. Entities

The definition of "exempt account" in FINRA Rule 4210(a)(13) includes accounts of brokers or dealers registered under the Exchange Act, banks, savings associations the deposits of which are insured by the Federal Deposit Insurance Corporation, insurance companies, investment companies registered with the SEC under the Investment Company Act, a state or political subdivision thereof, and pension or profit sharing plans subject to ERISA or of an agency of the United States or a state or a political subdivision thereof. For transactions in Covered Agency Securities, SIFMA recommends expanding this definition to include non-U.S. equivalents of these types of exempt accounts.

IV. Margin Collection and Transaction Liquidation

Pursuant to the Proposed Amendments, to the extent that a counterparty does not pay any required maintenance margin or marked to market loss, a member firm must deduct from its net capital, any uncollected margin at the close of business following the business day that the margin collection deficiency was created. Further, if such deficiency is not satisfied within five business days from the date the deficiency was created, the FINRA member must promptly take liquidating action, unless FINRA grants the firm an extension of time. SIFMA believes these timeframes are too short.

A. Conforming Timeframes

Under the SEC's Net Capital Rule, broker-dealers are not required to take a capital charge for uncollected margin until five business days after the margin call.[7] Member firms are not required to take liquidating action for uncollected margin until fifteen days after the margin call (or longer if FINRA provides an extension).[8] As noted above, SIFMA does not believe that Covered Agency Securities transactions represent a greater risk than transactions in other, generally more volatile, securities, like equities and high yield bonds. We therefore believe that Covered Agency Securities transactions should be subject to the same timeframes for capital charges and liquidating action as transactions in other securities, unless it can be demonstrated that there are special circumstances that render Covered Agency Securities transactions more risky. Inconsistent time periods for these purposes may be especially operationally difficult. In fact, the normal process of looking at a client's entire account to determine whether the client has adequate equity to satisfy Rule 4210's requirements would mean that it is impossible to attribute a margin deficit to Covered Agency Securities transactions rather than to other positions in the client's account.

B. The Proposed Timeframes Are Too Short

In addition to the operational issues for member firms arising from inconsistent timeframes, substantial operational changes would need to be made at member firms to accelerate the collection of margin in all cases to the day after the margin deficiency is created. Even with substantial operational changes, it may be very difficult to make margin calls early on T+1 when, for example, investment managers do not allocate transactions in Covered Agency Securities until T+1. Things are even worse on the client side. Many clients, even large and sophisticated investment managers, are unable to meet margin calls on the same day they are made. Some clients are located in different time zones, and closed for the day by the time the member firm delivers the margin call. In some cases, the margin may be posted in non-US currencies, requiring transfers in markets that have closed by the time the margin call is made. In some cases, stringent controls over the movement of funds and securities make it impossible to meet margin calls on the day that they are made. In other cases, there may be disputes about the proper size of the margin call that take some time to resolve. Thus, a one business day period for the collection of margin is simply unrealistic in many cases.[9]

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[7] Exchange Act Rule 15c3-1(c)(2)(xii).

[8] FINRA Rule 4210(f)(6).

[9] SIFMA recognizes that Rule 4210(g)(10)(B) requires that a FINRA member deduct the amount of a portfolio margin deficiency from its net capital on the next business day after the business day on

A short liquidation period is equally problematic. Where a member firm and its client differ on the amount of margin that is owed, it may take more than five business days to reconcile the requirements and resolve the dispute. Further, triggering liquidating action might have unintended consequences for the counterparty and the market generally by leading to cross defaults and further liquidating action. Rather than requiring a five-day liquidation period, SIFMA would support proposing that, if a client has not paid any required maintenance margin or marked to market loss within five business days from the date the margin collection deficiency was created, the client's ability to trade with the FINRA member in Covered Agency Securities should be limited to transactions that do not increase the risk of the client's position until the margin is posted or liquidating action is required. During this period, the FINRA member would take a capital charge for the deficiency, protecting the FINRA member from the exposure to the client.

SIFMA would support proposing the current fifteen-day timeframe from FINRA Rule 4210(f)(6) for bilateral transactions in Covered Agency Securities, especially since taking liquidating action with respect to such transactions, particularly new issue CMOs and Specified Pool Transactions, might take longer and be more complex than FINRA expects. SIFMA believes that a five-day liquidation period might be insufficient for firms to resolve disputes and to perform reconciliations. Further, triggering liquidating action might have unintended consequences for the counterparty and the market generally by leading to cross defaults and further liquidating action. A fifteen-day period would allow member firms to maintain consistent operations across positions and to avoid unnecessary liquidating action.

C. Extensions of Time in Certain Circumstances

If FINRA does not take our recommendation that the time periods for the collection of margin on Covered Agency Securities transactions be conformed to the generally applicable time periods under Exchange Act Rule 15c3-1(c)(2)(xii) and FINRA Rule 4210(f)(6), then we recommend that FINRA create electronic codes for requesting extensions on certain grounds and create automatic extensions for requests on those grounds. Grounds for automatic extensions should include:

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which such deficiency arises. That example should not be regarded as a guide for the appropriate timeframes for the current proposal. While a FINRA member can elect to apply the portfolio margin requirements set forth in Rule 4210(g) as opposed to the strategy-based margin requirements to a particular account, a FINRA member would not be able to opt out of the Proposed Amendments for any or all accounts. Further, the client base subject to the Proposed Amendments is much broader and qualitatively different from the client base subject to the portfolio margin rule. For example, unlike many non-U.S. clients that engage in Covered Agency Securities transactions, clients approved for portfolio margining are generally U.S. entities or at least have a manager operating during U.S. business hours. The issues flagged in the paragraph above are particularly relevant for the client base subject to the Proposed Amendments and generally do not apply for clients approved for portfolio margining.

- The existence of a bona fide dispute over the amount of margin required; and
- The occurrence of a holiday in the counterparty locale.

D. Tolerance of Relatively Small Margin Disputes

In the absence of definitive sources of objective pricing for Covered Agency Securities, disputes between FINRA members and counterparties over the proper amount of margin calls are inevitable. In the case of relatively small bona fide disputes over the amounts reflected in margin calls, SIFMA recommends that FINRA members be permitted to refrain from taking liquidating action even when the margin deficit (based on the member's calculation) remains uncollected beyond the liquidation cut-off date. In particular, SIFMA suggests that FINRA allow members to continue to take a capital charge on such margin deficits during the pendency of a bona fide dispute based on the member's valuation instead of requiring that the member take liquidating action. SIFMA would be happy to work with FINRA to set the appropriate measure of the relative size of the dispute (*e.g.*, the difference between the member and its counterparty's mark-to-market as a proportion of security value, the difference in margin call as a proportion of current exposure, potential future exposure or the credit limit set for the counterparty) and an appropriate limit to assure that the difference which would not trigger required liquidating action is relatively small.

E. Clarifications

SIFMA would like to confirm that "business day" for purposes of counting time until a capital charge is incurred or liquidating action is required based on required margin not being posted means the member firm's clearing day.

We would also like to confirm that, even if Rule 4210 is amended as proposed, members would be permitted to agree to negotiated time periods for the satisfaction of margin calls; provided that those time periods did not exceed the time before liquidating action would be required and any required capital charges are taken. For instance, a member firm and its counterparty could agree that if a margin call is made by 10:00 a.m., the counterparty would deliver margin by the close of business on the next business day and if the margin call is not made by such time on a business day, the counterparty could deliver margin by the close of business on the second following business day. In that case, if a call is made by 10:00 a.m. based on the prior day's closing price, and the counterparty does not deliver margin until it's due on the next business day, the member firm would have a capital charge for the uncollected margin on the day the call is made. If the call is not made until 10:15 and the counterparty does not deliver margin until the second following business day, the member firm would have a capital charge for the uncollected margin on the day the call is made and on the following day. Any member firm making such an agreement should, of course, analyze the effect on its capital and liquidity. This approach would be consistent with many existing client agreements and, therefore, would reduce the burden of member firms having to renegotiate existing client agreements.

V. De Minimis Transfer Amount

Under the Proposed Amendments, any margin that a member firm is required to collect with respect to bilateral transactions in Covered Agency Securities with a single counterparty need not be collected if the aggregate uncollected amount does not exceed $250,000 (the "de minimis transfer amount"), provided the member firm deducts such amount in computing net capital as provided in Exchange Act Rule 15c3-1. When the uncollected margin exceeds the de minimis transfer amount, the full amount must be collected by the member firm.

Rather than setting a specific de minimis transfer amount, SIFMA recommends that each member firm be allowed to consider its own needs and its client's needs to set a reasonable threshold below which margin would not need to be collected. Unlike a de minimis transfer amount, once the uncollected margin exceeds the threshold amount, the member firm would only be required to collect that amount exceeding the threshold. Member firms generally set credit limits with respect to their aggregate exposures to each counterparty—reflecting the entire credit risk that the counterparty may pose to the firm—rather than on a product-by-product basis. Member firms currently set thresholds for margin by considering a number of factors, including the counterparty's creditworthiness (*e.g.*, a higher threshold may be allowed for a more creditworthy counterparty), operational issues (*e.g.*, a higher threshold may be set to reduce the frequency with which margin needs to be transferred) and the use and availability of the member firm's capital and liquidity.[10] SIFMA believes that the determination of appropriate thresholds should continue to be established by member firm's credit departments, based on their evaluations of, and agreements with, counterparties. Rather than setting a hard limit, SIFMA suggests the FINRA require member firms to control these limits through a credit review process and require transactions in Covered Agency Securities to be governed by the MSFTA or other agreements with margin and default provisions. Such credit review should be incorporated into the requirement that member firms make a determination in writing of a risk limit to be applied to each counterparty.

Whether or not FINRA imposes a hard limit, SIFMA believes that member firms should not be required to take capital charges on uncollected deficiencies or

[10] In accordance with general industry practice, firms may also set low, but reasonable, generic limits without regard to the specific counterparty risk based on the risk of the transactions and member firm's own capital and liquidity. SIFMA recommends that such limits be expressly permitted without an individualized credit analysis.

marked to market losses below the threshold amount. (Or, if they are required to take a capital charge, the charge be only a portion of the uncollected amount, as is the case under the current rule.[11]) In particular, the establishment of a de minimis transfer amount with a requirement to take capital charges for the full amount of deficiencies and mark to market losses below the de minimis transfer amount would have an anti-competitive effect on smaller dealers, who are unable to absorb the capital charges as easily as larger dealers. In order to encourage the appropriate credit risk limits without penalizing smaller firms, SIFMA recommends not requiring a net capital charge on margin required below the threshold amount or the de minimis transfer amount.

VI. Concentrated Exposures

The Proposed Amendments amend current FINRA Rule 4210(e)(2)(H)(ii) (re-numbered to be FINRA Rule 4210(e)(2)(I)(ii)) so that its limits on net capital deductions for exempt accounts cover the deductions relating to bilateral transactions in Covered Agency Securities.[12] In particular, the Proposed Amendments would provide that, in the event the net capital deductions taken by a member firm as a result of deficiencies or marked to market losses incurred pursuant to certain good faith securities, highly rated foreign sovereign debt securities, and investment grade debt securities or bilateral transactions in Covered Agency Securities, exceed for any one account or group of commonly controlled accounts, 5% of the member firm's tentative net capital (as defined in Exchange Act Rule 15c3-1) or for all accounts combined, 25% of the member's tentative net capital (as defined in Exchange Act Rule 15c3-1) and such excess continues to exist on the fifth business day after it was incurred, the member firm shall give prompt written notice to FINRA and shall not enter into any new transactions that would result in an increase in the amount of such excess.

Given that FINRA is adding to the types of transactions for which deficiencies would contribute to the limits on net capital deductions, SIFMA recommends that FINRA raise the limit to 10% of tentative net capital for any one account or group of commonly controlled accounts, while maintaining the limit of 25% of tentative net capital for all accounts combined. As the limits were created before the addition of net

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[11] If FINRA requires the charge to be only a portion of the uncollected deficiency or marked to market loss below the threshold amount, SIFMA suggests that such percentage be uniform across exempt and non-exempt accounts for operational ease. The percentage should take into account the remaining time to settlement (for example, a 10% charge for uncollected margin below the threshold on transactions in Covered Agency Securities maturing in 120 days, a 25% charge for uncollected margin below the threshold on those settling 121 days to 1.5 years, and a 100% charge for uncollected margin below the threshold for those settling over 1.5 years).

[12] We believe (e)(2)(H) was inadvertently omitted from proposed (e)(2)(I)(i) and (ii). We think that the addition of (e)(2)(H) after (e)(2)(G) in the last clause of proposed (e)(2)(I) would only make sense if the same addition is made in two other places as well.

capital deductions resulting from deficiencies and marked to market losses relating to bilateral transactions in Covered Agency Securities and such net capital deductions will likely increase the amount of net capital deductions for member firms engaged in this business, SIFMA believes that the limit for any one account or group of commonly controlled accounts should be raised.

VII. Further Clarifications

A. Setoff of Profits and Losses

Proposed Rule 4210(e)(2)(H)(ii)(g) provides that unrealized profits in one Covered Agency Security position may offset losses from other Covered Agency Security positions of the same counterparty account and the amount of net unrealized profits may be used to reduce margin requirements. The proposed section then says "[o]nly profits (in-the-money amounts), if any on 'long' standbys are recognized." SIFMA notes that the second sentence of proposed Rule 4210(e)(2)(H)(ii)(g) might be read to limit the entire provision to profits on long standbys, rather than clarifying that for long standbys only profits (not losses) may be factored into the setoff permitted by the first sentence. SIFMA believes the final sentence should be reworded to clarify its meaning.

B. Cured Deficiencies

Proposed Supplementary Material .03 specifies that, to the extent a deficiency is cured by subsequent market movements prior to the time the margin call must be met, the margin call need not be met and the member need not take liquidating action with respect to the position; provided, however, the deduction from net capital shall be applied on the date following the creation of the deficit. SIFMA recommends that FINRA clarify whether a member firm would be required to take a capital charge on deficiencies on the day such deficiencies are cured or whether such cure only affects the member firm on the business day following the cure.

C. Eligible Collateral

In RN 14-02, FINRA states that it believes that "all margin eligible securities, with the appropriate margin requirement, should be permitted as collateral to satisfy required margin." While SIFMA supports giving member firms the flexibility to allow any margin eligible securities as collateral for Covered Agency Securities transactions, we would like FINRA to clarify that it is making no recommendation as to what type of eligible collateral a FINRA member should accept. In particular, SIFMA believes that each member firm should make its own decision as to the types of eligible collateral that it would accept to satisfy the required margin, based on its own credit determination and operational capabilities. While certain FINRA members might accept corporate bonds and equity securities as collateral, other FINRA members might determine that limiting collateral to cash or U.S. Treasuries best serves such member's business objectives and operational capabilities.

D. Risk Limits

Proposed Rule 4210(e)(2)(H)(ii)(B) would require member firms that engage in Covered Agency Securities transactions with any counterparty to make a determination in writing of a risk limit to be applied to each such counterparty. SIFMA would like confirmation that member firms may set limits for customers across all product lines, rather than a specific limit only for Covered Agency Securities transactions.[13]

VIII. Impact on Smaller Member Firms

SIFMA would like to stress that many of the points made in this letter are of particular concern to smaller member firms. For one thing, smaller member firms are not primary dealers and many of them have not applied the TMPG Best Practices to all their client relationships. Thus, negotiations with clients concerning margin collection with respect to Covered Agency Transactions will be new to many such firms and the costs and time required to implement the Proposed Amendments might very well be proportionally higher. Combined with the fact that smaller member firms have smaller compliance and operational staff with which to implement and comply with the Proposed Amendments, the impact of the Proposed Amendments is particularly acute with respect to such firms. Smaller firms are an important segment of the market in Covered Agency Securities, especially as regards retail investor participation in the CMO market and services to smaller banks and buy-side firms. SIFMA recommends that FINRA consider the acute effects of the Proposed Amendments on the smaller member firms.

IX. Implementation Period

In RN 14-02, FINRA seeks comment on the appropriate amount of time needed to implement the changes provided for in the Proposed Amendments. SIFMA believes that an implementation period of eighteen months after approval would be appropriate. The Proposed Amendments would require member firms and their clients to make numerous operational changes. The process to make such changes will be burdensome and costly, especially for member firms that are not primary dealers and have not applied the TMPG Best Practices to all of their client relationships. Member firms that are not already margining positions in Covered Agency Securities will face operational hurdles to beginning such margining. In addition, all member firms will have to adopt

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[13] As mentioned in footnote 10 above, SIFMA also recommends that FINRA confirm that member firms may continue to follow general industry practice in setting low, but reasonable, generic limits based on the risk of the transactions and member firm's own capital and liquidity, without an individualized credit analysis of the counterparty.

written risk policies and procedures and make written credit risk limit determinations for each counterparty pursuant to such policies and procedures. Further, member firms will have to make determinations for each counterparty about whether such counterparty is an exempt account. And even member firms that have implemented the TMPG Best Practices will have to amend a significant proportion of the MSFTAs or other agreements already in place, if the proposed amendments regarding the timing of margin collection and liquidation are adopted. In addition, many member firms will be complying with documentation and margining requirements for the first time. These burdens and costs are heightened when combined with the fact that member firms are simultaneously responding to regulatory changes in many other aspects of their business affecting their relationship and documentation with the same clients.

Moving to shortened time periods for collection of margin and liquidation would be very disruptive to current practices. Many member firms spent a significant part of the past year negotiating agreements to margin their Covered Agency Securities transactions. Part of those negotiations was negotiation of the grace periods for the provision of margin. Member firms generally took into account the standard periods in Regulation T, FINRA Rule 4210(f)(6) and Exchange Act Rule 15c3-1(c)(2)(xii), but many of those agreements would need to be renegotiated if member firms needed to collect margin on the day after the deficiency is created (which generally would mean margin must be posted on the same day as the margin call is made). The renegotiation would be very costly and time consuming.

Given the extensive and complex operational changes necessitated by the Proposed Amendments, SIFMA believes that eighteen months would be an appropriate period before implementation. SIFMA notes that the TMPG, which initially recommended six months for implementation of its Best Practices, extended that period to twelve months, and even then only for substantial completion. In fact, at the end of January 2014, primary dealers had, on average, executed margining agreements with roughly 55% of their counterparties, which covered roughly 75% of the notional amount of their Covered Agency Security transactions.[14] Given that FINRA would require complete implementation by all member firms, the number of member firms affected will be more numerous and they will vary in size and ability to make necessary operational changes, a period longer than the twelve months recommended by the TMPG is advisable.

Further, SIFMA notes that the recommendation for an eighteen month implementation period assumes that the Securities and Exchange Commission will have issued interpretations or other guidance with respect to the SEC's net capital and

[14] Federal Reserve Bank of New York, "TMPG Meeting Minutes" (Feb. 11, 2014), *available at* http://www.newyorkfed.org/tmpg/february_minutes_2014.pdf.

customer protection rules' treatment of customer (and PAB) margin collected for transactions in Covered Agency Securities. The following are just a few of the areas that would need to be clarified before firms could implement the Proposed Amendments:

- The rights of a dealer to use cash or securities received as mark-to-market or other margin on Covered Agency Securities transactions in a customer (or PAB) account (including for the delivery of margin for the dealer's related transactions with bilateral counterparties or cleared by the MBSD);
- The effects of such use on the customer (and PAB) reserve formula; and
- The manner in which a non-clearing firm exempt from Rule 15c3-3 under Rule 15c3-3(k)(2)(ii) can collect and maintain margin required by Rule 4210 (especially in circumstances where the clearing firm acts solely as settlement agent, without responsibility for the Covered Agency Securities transactions).

To the extent that such interpretations are not issued by the time the amendments to Rule 4210 are published, SIFMA believes that a longer implementation period would be appropriate.

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SIFMA appreciates the opportunity to comment on the Proposed Amendments. Should you have any questions regarding our comments, please do not hesitate to contact the undersigned at the numbers below.

Sincerely,

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March 28, 2014

Submitted via Email to pubcom@finra.org
Marcia E. Asquith
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, DC 20006-1506

Re: Proposed Amendments to FINRA Rule 4210 for TBA Transactions

Dear Ms. Asquith:

The Asset Management Group ("**AMG**")[1] of the Securities Industry and Financial Markets Association ("**SIFMA**") is pleased to submit this letter to the Financial Industry Regulatory Authority ("**FINRA**") in response to FINRA's request for comment on its proposed amendments to FINRA Rule 4210 which would establish margin requirements for transactions in "Covered Agency Securities," which include transactions in the "To-Be-Announced" ("**TBA**") market[2] (the "**Proposed Amendments**").

AMG generally supports the aim of the Proposed Amendments to mitigate the counterparty credit risk borne by participants in the TBA market and reduce the potential for systemic risk. However, we have the following comments on the Proposed Amendments, each as discussed further below: (i) the maintenance margin requirement should be eliminated; (ii) "liquidating action" should not be mandated by the Proposed Amendments; (iii) "commonly controlled accounts" should not include accounts by virtue of being managed by the same asset manager; (iv) the parties to Covered Agency Securities should be free to negotiate the settlement period for posting margin up to a three-day period after a margin call; (v) certain technical changes should be made to the Proposed Amendments; and (vi) the compliance date for the Proposed Amendments should be 18 months following effectiveness.

[1] AMG's members represent U.S. asset management firms whose combined assets under management exceed $20 trillion. The clients of AMG member firms include, among others, registered investment companies, ERISA plans and state and local government pension funds, many of whom invest in commodity futures, options, and swaps as part of their respective investment strategies.

[2] The TBA market includes transactions in adjustable rate mortgages ("**ARMs**"), Specified Pool Transactions and Collateralized Mortgage Obligations ("**CMOs**") with forward settlement dates.

I. The Maintenance Margin Requirement Should Be Eliminated

AMG feels strongly that the requirement for maintenance margin should be eliminated from the Proposed Amendments.[3] The issue is not a new one. In developing its Best Practices for Treasury, Agency Debt and Agency Mortgage-Backed Securities Markets (the "**TMPG Best Practices**"),[4] the Treasury Market Practices Group (the "**TMPG**") carefully considered – then rejected – the idea of imposing initial (or "maintenance") margin in the TBA Market. The TMPG Best Practices currently contains no such requirement. AMG generally supports the TMPG Best Practices and believes that FINRA rules should generally be consistent with them. For FINRA to require Members to collect maintenance margin from non-exempt customers would force those customers to transact with non-Member banks and severely fragment the market.[5]

AMG believes that there is no compelling reason to impose a maintenance margin requirement in the TBA market. The purpose of maintenance margin is to protect a party from potential future exposure to changes in the marked-to-market value of securities during the "liquidation period" in which the position is being closed out or replaced, following a default by its counterparty. The amount of maintenance margin reflects an estimate of this potential future exposure and depends in large part on the expected duration of the liquidation period. The greater the liquidity of an instrument, the shorter the liquidation period is likely to be. The TBA market is extremely liquid. First, the aggregate size of the market is extremely large.[6] Second, the TBA market is limited to securities sponsored by government-sponsored agencies ("**agency MBS**") which benefit from agency guarantees of payment of principal and interest on the underlying mortgages. Third, agency MBS are subject to either an explicit or implicit government credit guarantee. Fourth, transactions in the TBA market are highly homogenous. Since the identity of the mortgages in the agency MBS to be delivered at settlement is not specified on the trade date, TBAs trade solely on the basis of six general parameters of the securities to be delivered (issuer, maturity, coupon, price, par amount, and settlement date). Finally, TBAs trade on a "cheapest to deliver" basis, making settlement easier and increasing liquidity. With such vast liquidity, TBA market participants should be able to liquidate and replace defaulted positions easily and quickly, with minimal risk of exposure to changes in the

[3] The Proposed Amendments provide that for bilateral transactions with non-exempt accounts, FINRA members ("**Members**") must collect, in addition to variation margin, maintenance margin equal to two percent (2%) of the market value of the securities subject to the transaction. If sufficient margin is not collected, the Member will be required to deduct the uncollected amount from the Member's net capital at the close of business following the business day on which the deficiency was created. Additionally, if the deficiency in margin is not satisfied within five business days, the Member must take liquidating action, unless FINRA grants the Member an extension.

[4] Treasury Markets Practice Group, Best Practices for Treasury, Agency Debt, and Agency Mortgage-Backed Securities Markets, Revised May 2013 (*available at* www.newyorkfed.org/tmpg).

[5] As discussed further in Section II herein, the Proposed Amendments require a net capital deduction and the obligation to take liquidating action for both exempt and non-exempt accounts.

[6] "The TBA market is the most liquid, and consequently the most important secondary market for mortgage loans. . . . [A]n average of $246 billion of agency MBS was traded each day in March 2013 . . . ." SIFMA, TBA Market Fact Sheet: The TBA Market, 2013 (av*ailable at* http://www.sifma.org/).

marked-to-market value of the securities that are the subject of the transaction. As a result, there is no need for maintenance margin in the TBA market.

The proposed maintenance margin requirements will adversely affect the market. Because the requirements are only applicable to non-exempt accounts, the costs would be borne by smaller market participants. In addition, asset managers may only be able to deliver information relating to assets under their management, not the full financials for a separately managed account client. In such a scenario, clients who would otherwise be exempt accounts might nonetheless be required to post maintenance margin because asset managers will be unable to provide dealers with sufficient financial information to take them out of the scope of the proposed requirements. As a result, such smaller clients and separately managed account clients are likely to be driven out of this investment space or pushed to transact with non-Member banks, causing consolidation and reduced liquidity. Such reduced liquidity will increase hedging costs for mortgage originators and the cost of mortgages for homeowners.[7]

Maintenance margin will also introduce new credit exposures and market risks. By posting maintenance margin to protect a Member against its counterparty's default, the counterparty risks losing this amount if the Member defaults. The maintenance margin requirement also decreases liquidity by freezing large amounts of high quality collateral, which could increase systemic risk. In addition, counterparties may have to borrow to meet maintenance margin requirements, which would shift risk into the funding markets.

Finally, the one-size-fits-all requirement of two percent mandatory maintenance margin on all non-exempt accounts is too blunt an instrument; instead the parties closest to the transaction are best positioned to determine the need for, and amount of, maintenance margin in each transaction. The Proposed Amendments already require Members to assign a risk limit determination to "any counterparty" with which it will engage in relevant transactions. AMG believes that this risk assessment could be more properly used as a tool to determine the counterparties from whom a Member would require maintenance margin.

II. "Liquidating Action" Should Not Be Mandated by the Proposed Amendments

The Proposed Amendments provide that if a counterparty does not pay required maintenance margin or a marked-to-market loss, a Member must deduct from its net capital any uncollected margin at the close of business following the business day that the margin collection deficiency was created. Any margin deficiencies not satisfied within five business days from when the deficiency was created require the Member to promptly take "liquidating action," unless granted an extension of time by FINRA.[8] We believe that this requirement is too heavy-handed an approach, and we suggest that FINRA align its position with that of TMPG which

[7] See Vickery & Wright, TBA Trading and Liquidity in the Agency MBS Market, Federal Reserve Bank of New York Staff Report no. 468 (Aug 2010) (concluding that the TBA trading convention "significantly improves agency MBS liquidity, leading to lower borrowing costs for households.").

[8] FINRA Rule 4210(e)(2)(H)(ii)(e).

considered and rejected mandating liquidating action after a failure to post margin. Accordingly, no such requirement appears in the TMPG Best Practices.

Whether to liquidate trading positions in the face of a counterparty failure to post margin is a business decision and should not be mandated by rulemaking. In standard collateral documentation, following a default and any applicable cure period, the non-defaulting party typically has the right – but not the obligation – to liquidate, close out and set off. Depending on the nature of the relationship with the counterparty, the reason for the default, the likelihood of curing the default, the market for the collateral, and the size of the positions, there may be reasons for the non-defaulting party to refrain from or delay liquidating positions. For example, the template Master Securities Forward Transaction Agreement ("**MSFTA**") published by SIFMA defines "Event of Default" to include any failure by a party to meet its margin obligations, but permits the parties to negotiate whether to include a cure period and how long that period should be. Following an Event of Default, the "non-defaulting party may, at its option, declare an Event of Default to have occurred" and only then, liquidate and close out all transactions under the MSFTA. Such contractual discretion is designed to allow the parties to tailor their arrangements to the particular circumstances and provide them with flexibility on when (or whether) to exercise any available contractual remedies.

In contrast, the Proposed Amendments would impose inflexible and overly aggressive, one-size-fits-all time frames. In the case of a legitimate dispute (for example, a dispute over calculation of exposure), the five-business day period is unlikely to allow sufficient time for resolution before the close-out period has run.[9] Nor do the required time frames for posting of margin account for cross-border transactions involving different time zones. Finally, mandating liquidating actions may drive market participants to transact with counterparties that are not subject to such restrictions, such as banks, thereby fragmenting the market and diminishing the competitiveness of FINRA Members in the marketplace. In sum, the parties should be free to negotiate their own provisions relating to the posting of margin, liquidation, and the related time frames.

III. "Commonly Controlled Accounts" Should Not Include Accounts by Virtue of Being Managed by the Same Asset Manager

Under Section (e)(2)(I)(ii)(a) of the Proposed Amendments, Members would be required to provide written notification to FINRA and would be prohibited from entering into any new transactions with exempt accounts that would result in increased credit exposure if net capital deductions resulting from deficiencies in collecting margin or marked-to-market losses over a five-business day period exceed five percent of the Member's tentative net capital for a single account or group of ***commonly controlled accounts***, or 25 percent of the Member's tentative net capital for all such accounts combined.

[9] We request that, at a minimum, FINRA clarify this provision by providing that in the event of a legitimate dispute, the five-business day period does not apply.

The term, “commonly controlled accounts,” is used in Section (e)(2)(I)(ii)(a) but undefined in Rule 4210. FINRA Rule 0160(a) provides that terms not defined in FINRA rules are to be defined as set forth in the FINRA By-Laws, if a definition is provided therein. Article 1(h) of the FINRA By-Laws defines the word “controlling” to mean “the possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting stock, by contract or otherwise.”[10]

It is our understanding that this definition excludes accounts that are related by virtue of being managed by the same asset manager, and we request that the Proposed Amendments clarify that this is the case. Accounts do not share the same credit profile simply because they share an asset manager and aggregating the exposure for such accounts is not indicative of greater credit risk with respect to any individual account. Further, because there is no recourse among the various accounts of a single investment manager, grouping such accounts together for the purposes of determining credit exposure will not mitigate risk.

IV. The Parties to Covered Agency Security Transactions Should Be Free to Negotiate the Settlement Period for Posting Margin Up to a Three-day Period After the Margin Call

The time allowed under the Proposed Amendments for parties to post margin is insufficient given differences in international time zones and holidays and the potential for operational delays. Under the Proposed Amendments, when a counterparty does not pay the required maintenance margin or the Member’s marked-to-market loss, the Member must deduct from its net capital any uncollected margin at the end of the day following the business day of the creation of the deficiency. This timeline effectively requires margin to be posted the day after a margin call. Instead, counterparties should be free to negotiate their own settlement timelines, subject to a three-day maximum period, to accommodate the specific circumstances of individual transactions.

A margin settlement period of only a single day after the margin call fails to account for the different circumstances presented by differently situated market participants. Members may be transacting with counterparties located in different time zones, which would create inconsistencies in time frames for posting margin. Non-domestic counterparties may also have different holiday schedules, leading to complications in determining the business day on which margin must be posted and requiring the extension of the margin settlement period. Additionally, clients whose assets are held by custodians create notable operational delays. The significant lag time in dealing with customers who must operate through custodians (for example, in offshore transactions or transactions in non-domestic currencies) makes such a short margin settlement period infeasible. Moreover, when transacting with counterparties using non-domestic currencies, the counterparty must have sufficient time to exchange the foreign currency for use as collateral in domestic currency. This currency conversion will be done on spot foreign exchange markets and will generally introduce an additional two-day settlement cycle. At best, such a counterparty may execute the foreign exchange transaction – at an increased cost – on a one-day settlement cycle, but this will still introduce an additional day into the margin settlement

[10] It also contains a rebuttable presumption that ownership of 20% or more of the voting stock of an entity constitutes control, along with certain exceptions.

period. Moving to a settlement period of one day after the margin call would change longstanding practices for certain asset managers across portions of their client base, requiring costly and burdensome systems and operational changes for those asset managers. Thus, we propose that margin settlement be extended to three days following the call for margin with an allowance for parties to negotiate shorter margin settlement periods for individual transactions.

V. Certain Technical Changes Should Be Made to the Proposed Amendments

A. Scope. As previously indicated, we generally support the TMPG Best Practices. Nevertheless, there are some scoping issues that we think should be addressed. For example, we agree with the Proposed Amendment's exclusion of "central banks" from the margin requirements under Rule 4210. Section (e)(2)(H)(ii)(a) of the Proposed Amendments makes clear that transactions in Covered Agency Securities with a counterparty that is a "central bank" would not be subject to margin requirements under Rule 4210. Footnote 23 of Regulatory Notice 14-02 states that that "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."[11] AMG requests that FINRA codify this interpretation directly into Rule 4210. In addition, we believe that sovereigns typically make investments through specialized investment vehicles which they guarantee. Such sovereign wealth funds present credit profiles that are substantially similar to those of the sovereign itself. Accordingly, AMG requests that sovereign wealth funds be explicitly excluded from the purview of Rule 4210.

Finally, despite our general agreement with the TMPG Best Practices, we have previously expressed our objection to including securities with T+2 or T+3 settlement cycles within the scope of their recommendations. Some of our members maintain this objection as they believe it would unnecessarily impede liquidity and do little to reduce credit exposure or mitigate systemic risk, and they believe the margin requirements should match the standard settlement cycles of the spot market for those securities (i.e., from greater than T+1 to greater than T+3). We continue to engage in discussions with the TMPG on this subject. Recognizing the need to have consistency in the regulation of the TBA market and to avoid market fragmentation, we recommend that if, and to the extent that, either the TMPG or FINRA modifies the scope of inclusion of these instruments, then the organizations work together to harmonize their provisions.

B. Bilateral Variation Margin Should Be Permissible. AMG believes that the Proposed Amendments should clarify that the counterparties may agree to adopt bilateral variation margin. Under the current version of the Proposed Amendments, a Member must collect any mark-to-market loss in excess of the *de minimis* transfer amount within one business day, or deduct the deficiency from the Member's net capital until such deficiency is satisfied. Although Regulatory Notice 14-02[12] implies that this variation margin may be bilateral,[13] the text of the Proposed

[11] Regulatory Notice 14-02, p. 11 n. 23.

[12] FINRA Regulatory Notice 14-02, <u>Margin Requirements: FINRA Requests Comment on Proposed Amendments to FINRA Rule 4210 for Transactions in the TBA Market</u>, Jan. 2014.

Amendment indicates that, unless the transaction is between two Members, variation margin is applied only one way. Bilateral variation margining should be supported as a means to mitigate the credit risk that non-Member market participants will have with respect to their Member counterparties and may help with the reduction of systemic risk. This is consistent with the approach in the TMPG Best Practices, which states that in order to help *both* parties mitigate counterparty risk, "two-way variation margin should be exchanged on a regular basis."[14]

C. Omnibus Accounts. Supplementary Material .04 to the Proposed Amendments says that the determination of whether an account qualifies as an exempt account shall be made based on the beneficial owner of the account, and subaccounts managed by an investment adviser, where the beneficial owner is other than the investment adviser, shall be margined individually. To the extent that maintenance margin is required under the final version of the Rule, AMG would like to confirm that this principle applies only where the investment adviser manages multiple subaccounts. Conversely, where an investment adviser manages a single omnibus account and has agreed that the account may be treated as the account of a single principal, the determination of exempt account status should be made based on the status of the entire account and that no information about the underlying beneficial owners needs to be obtained by the Member.

VI. The Compliance Date for the Proposed Amendments Should Be 18 Months Following Effectiveness

The Proposed Amendments should have a compliance date that is at least 18 months following the date of their effectiveness. This time period would allow Members and non-Members to change necessary systems and documentation, as well as educate clients, so as to be able to comply with Rule 4210. The market's experience with the TMPG Best Practices is instructive. Due to the very broad participation in the market for Covered Agency Securities, despite diligent efforts, banks were unable to negotiate and execute MSFTA agreements with significant numbers of their clients within the period established by the TMPG. An equally long period of time should be expected to implement the Proposed Amendments.

* * *

[13] *See id.* at 4 ("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)) (emphasis added).

[14] TMPG Best Practices, p. 3.

The AMG appreciates the opportunity to comment on the Proposed Amendments. Should you have any questions regarding our comments, please do not hesitate to call Tim Cameron at 212-313-1389, Matt Nevins at 212-313-1176 or Dan Budofsky of Bingham McCutchen LLP at 212-705-7546.

Sincerely,

Timothy W. Cameron, Esq.
Managing Director, Asset Management Group
Securities Industry and Financial Markets Association

Matthew J. Nevins, Esq.
Managing Director and Associate General Counsel, Asset Management Group
Securities Industry and Financial Markets Association

March 28, 2014

<u>Comments on Proposed Amendments to FINRA Rule 4210 regarding TBA Margin Requirements.</u>

Thank you for the opportunity to offer comments on proposed FINRA Rule 4210 regarding TBA Margin Requirements. While we absolutely agree with FINRA's efforts to protect investors, we believe the proposal in its current form may cause greater harm, not only to investors, but to the markets, consumers, mortgage brokers and smaller broker dealers.

In over 30 years of experience in the various fixed-income markets, we have yet to see the degradation of value between trade date and settlement date in mortgage-backed securities such as these cause great harm to the parties involved in the transactions. However, we are seriously concerned about the harm this proposal will cause to smaller broker dealers, smaller mortgage brokers and smaller investors and consumers. Large institutional broker dealers, mortgage companies and investors probably will not be greatly affected. However, the aforementioned smaller investors and entities will lose access to markets and those individuals and entities will likely fall out of the marketplace completely. Smaller mortgage brokers, who do not have access to primary dealers, depend on the smaller broker dealer to provide liquidity and market access for their pooled mortgage products. Their ability to pool mortgages and bring them to market assists in keeping mortgage rates lower, thereby helping consumers. Because of the size of these transactions, the margin proposal in its current form would force both the small broker dealers and smaller mortgage brokers and lenders out of the marketplace altogether, which would, in turn, cause an increase in mortgage rates, thereby harming consumers.

Another casualty of the proposal could be that some of the market participants will move the activity to entities that are not regulated by FINRA. Bank affiliated broker dealers who have become FINRA members will be forced to move the business to the bank dealer side in order to remain a viable market participant. Another problem created by these moves is the inability of having clearing firms assist in the settlement of these transactions and collection of margin due to the capital charges involved. This will create an enormous expense for smaller firms who wish to continue participate in the markets, in that they will have to expand their back office operations to handle the settlement of this activity. For introducing broker dealers, this could cause them to be removed from the marketplace for a time while obtaining approval to be a self-clearing firm.

In addition to the above, we would reiterate the comments of Ambassador Financial Group, to-wit:

> "Even if smaller brokerage firms do survive, the proposed risk limitations may have a great impact on their ability to service clients. As risk limits are approached, brokerage firms will be regulatorily required to cut off access to markets. As market access is reduced or eliminated the number of potential market participants is reduced. The fewer available market participants the less liquid the securities. The less liquid the securities the more volatile the markets. If the need for covering margin requirements is triggered it is most likely because

markets are struggling to start with. Without the margin requirement and risk limit restraints there is a better chance of stabilizing markets. Using history as a guide, no matter the condition of markets, trades settle anyway. Counterparties honor their commitments. Other than a single trade with Bear Stearns that we learned was never booked in the confusion of their last days, we have never been witness to a transaction in which a counterparty has backed away from an agreed upon trade.

From the perspective of the end investor it is reasonable to believe that given increased recordkeeping requirements along with the potential need for posting collateral prior to settlement fewer investors will have interest in buying mortgage backed securities. Looking at our client base, bankers may have an added incentive to shy away from investing in the MBS markets, quite possibly and understandably being disturbed at having to post collateral to buy securities they want to use as collateral. Not only will fewer MBS market participants potentially lead to a less liquid market but there may also be the unintended consequence of less money available for homebuyers looking for mortgages…

The riskless principal option itself may also be in peril. The riskless principal model is a valuable one, providing investors with a broker source that, rather than selling bonds from inventory, shops the market for the most appropriate investment option available unencumbered by positions the firm might hold. Low capital requirements are an incentive for firms to follow this model. The higher effective capital requirements of the proposed rules amendment may force riskless principals out of business, or limit what they can offer. Fewer firms following the riskless principal model means fewer options for end investors. We also believe that FINRA is a stronger and more effective organization with more rather than fewer members. A tiered system is already in place with those financial services organizations that are FINRA regulated and those that are not. Possibly a tiered system within FINRA that would exempt riskless principal model brokers from the MBS variation margin requirements and exposure limitations would be worthy of consideration if the rule changes cannot be set aside altogether.

From a firm perspective, despite maintaining capital that far exceeds our required level, there are very real impediments to our viability if these proposals become rule. In a volatile market both the 5% limit per client and the 25% overall limit could be reached easily. While it is understood that the intended purpose of limits is to avoid overwhelming exposure the idea that triggering these limits and reducing market access when clients may need that market access most acutely appears it would create more systemic risk rather than less.

The proposal to require the posting of variation margin based on mark-to-market calculations is also of great concern to us… Most likely if the de minimis level is reached with one of our brokerage counterparties the exposure would be spread out over a number of exempt clients who would not reach their de minimis threshold creating a funds imbalance until settlement day. It is understood that book profits will offset book losses in calculating exposure however much investment is done with cash and there is less potentially offsetting sell side activity. Additionally if markets are sliding rapidly bid to offer spreads often widen, magnifying the loss and reducing the profit side benefit.

To continue along the lines of bid to offer spreads and market value of securities, how will securities be valued? TBA pools are relatively easy to price in a universally accepted manner. CMOs and specified pools are considerably harder to value. This point is brought home to us every time we look to the street for bids for client securities. Certainly the closer to generic a pool gets the easier it is to value. However there are many characteristics that affect the value of a mortgage backed security. Among those characteristics are pool size, median loan size, geographic dispersion, and underlying credit. CMOs with their many different structures are even harder to value. How will these securities be valued? Yes market values are placed on bonds everyday however it is our experience that pricing services can be grossly inaccurate particularly in volatile markets. Even small price differences could mean the difference between having to post collateral or not."

Again, we appreciate the opportunity to present our comments on this proposal and thank you for your careful consideration of same.

Respectfully Submitted,

Simmons First Investment Group, Inc.

Richard Johnson, President

Harold Thomas, CCO

Carolyn R. May, Co-CCO, Advisory Director

March 28, 2014

Marcia E. Asquith
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington. D.C. 20006

VIA ELECTRONIC MAIL

RE: Request for Comment on Proposed Amendments to FINRA Rule 4210 for Transactions in the TBA Market (Regulatory Notice 14-02)

Dear Ms. Asquith,

Vining Sparks appreciates the opportunity to submit this letter in response to FINRA's solicitation of comments in connection with Regulatory Notice 14-02, proposed amendments to FINRA Rule 4210. This letter begins with a discussion of why we believe the proposed amendments should be tempered by limiting the types of counterparties subject to variation margin requirements on Covered Agency Securities. Following this request, additional topics that FINRA requested feedback on related to the current amendments, as proposed, are covered, including questions, comments and suggestions for FINRA to consider in an effort to help make the amendments effective, operable, fair and minimally disruptive for member firms.

Exemption Request

Vining Sparks agrees with well thought through efforts to improve the safety, soundness and reputation of member firms and the securities industry as a whole and to ensure the protection of customer assets. We understand that FINRA is attempting to synch up their rules with rules recently implemented for primary dealers by the Treasury Market Practices Group. We also generally support the proposed amendments to FINRA Rule 4210 when applied to: 1) TBA trades; 2) specified pool, arm pool and CMO trades settling beyond the next good settlement date or outside of the current settlement cycle (typically no more than 35 days beyond trade date) ;

and 3) trades with non-regulated highly leveraged counterparties. However, we believe that **the proposed amendments to FINRA Rule 4210 over-reach the stated goal of settlement risk reduction in the TBA / MBS market by requiring *regulated customers* to post margin on trades that they have no history of failing to honor**. Since our firm's inception in the early 80s, and after executing well over 200,000 Covered Agency Securities trades with regional and community banks, credit unions and savings banks, **we have never had a regulated institution fail to honor a trade in any of the securities that the proposed Rule 4210 amendments would require to be margined**. Simply stated, the expansion of variation margin requirements to regulated entities is an attempt to solve a problem that we have not heard of, witnessed, or experienced.

In the Background and Discussion Section of Regulatory Notice 14-02, FINRA makes the very general statement that "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 of as long as six months past trade date." While this may be a true statement for the market overall, this is not a fair representation of the type of business conducted by regulated entities such as regional and community banks, credit unions and savings banks. Over the last 3 years, less than 4% of the Covered Agency Security trades that our firm executed with regulated entities were TBA trades. The other 96% of the trades were specified pools, arms or CMOs, almost all of which settled within the current settlement cycle. Our firm's trading history should fairly represent, within a reasonable range, that of other institutional focused regional broker dealers that serve regulated entities.

Since most trades in the MBS market are TBA trades, TBA's generally have longer settlement terms and carry greater mark to market risk than non-TBAs, and the most risky segment of the market trading TBAs are unregulated & sometimes highly leveraged customers, we believe FINRA's rule change would be far more effective and efficient if only TBAs with non-regulated entities were included in the amendment. This would encompass the vast majority of what the TMPG has forced primary dealers to margin. We understand that FINRA is attempting to synch their regulations up with the TMPG rule applicable to primary dealers, but primary dealers typically serve a different market than regional broker dealers. Most member firms do not have the same risk profile as primary dealers and FINRA needs to fully consider this when enacting rule changes.

Once again, we understand and support the need to reduce the risks associated with non-settlement of TBA trades with highly leveraged non-regulated entities, where such an event could, theoretically, create hardships for member firms that lack adequate risk controls if such a counterparty went out of business prior to the settlement of pending trades. However, regional and community banks, credit unions and savings banks typically take delivery of such securities on the next good settlement date for the type of security traded, generally within one month of the trade date. Such entities are also regulated by what the Dodd Frank Act described as "Prudential Regulators". We believe that the proposed rule change penalizes regulated entities in order to protect the overall market from non-regulated entities that are allowed to take on elevated levels of risk. **For all of the above reasons, we ask that FINRA consider exempting entities regulated by Prudential Regulators from being required to post variation margin on any specified pool, arm pool or CMO trade with settlement terms within the current settlement cycle.**

The following subsections deal with specific points that FINRA has asked member firms to provide commentary on related to the proposed amendments:

Identification of counterparties that will require a MSFTA

After FINRA implements these amendments, will FINRA **require** a FINRA member to have an executed MSFTA in place **prior to** transacting **any** Covered Agency Security trade with a customer? Will FINRA require member firms to establish a MSFTA with a new customer when opening a new account? Might FINRA implement a par size cap and/or a trade frequency cap on members with specific counterparties over which MSFTA documentation must be gathered and put in place prior to executing additional or larger trades? Guidance from FINRA on these questions will allow member firms to better plan for the resulting operational changes they will face.

Mortgage Banking customers, dealers and other customers that frequently purchase Covered Agency Securities on a regular basis are easily identifiable and members should start the MSFTA documentation process early with such counterparties in order to comply with this upcoming rule change. Of immediate concern, however, are customers that infrequently purchase Covered Agency Securities and/or that purchase small lots of Covered Agency Securities. Such counterparties can number in the many hundreds or few thousands for regional member firms. The execution of a MSFTA with each such counterparty would be extremely burdensome, costly and time-consuming and in most instances, unnecessary since such counterparties may never approach a mark to market call requirement. Often, member firms will not know whether a counterparty will need a MSFTA until a trade with such counterparty uncovers a potential need for margin, and by then it is too late to initiate the MSFTA collection process and margin transfer in time to meet the five day close out requirement that FINRA currently recommends in the proposed amendment. Will FINRA allow member firms a grace period to execute a MSFTA with the counterparty in such a situation? Will FINRA monitor and enforce the margin requirements and proposed close out requirements differently depending on the type of counterparty or based on a firm's history with such counterparty?

Since FINRA is proposing a $250,000 de minimis threshold under which margin is not required to be collected on Covered Agency Security trades, we request FINRA to consider allowing member firms to use their professional judgment when deciding whether or not to attempt to begin MSFTA documentation proceedings with specific counterparties based on the counterparties recent trading patterns. In other words, if recent trading patterns suggest that a counterparty would not be likely to trade a large position or trade frequently, we would request that the acquisition of MSFTA documentation not be required by FINRA. Also, we request that FINRA allow a grace period for acquiring a MSFTA after identification of trades on which margin may ultimately be required.

Close out requirement for non-transfer of margin after 5 days

FINRA's proposed close out requirement, while perhaps workable for clients with whom the broker-dealer has an MSFTA, is unworkable for clients with whom the broker-dealer does not have an MSFTA. Unless FINRA expects broker-dealers to have MSFTA's in place as a pre-requisite for opening an account, there are a number of legitimate situations whereby a customer account may not yet have an MSFTA. Examples include either an account that the dealer did not expect to have sufficient exposure with to warrant an MSFTA or a situation where the broker-dealer is in the process of obtaining the MSFTA from the account but the account has not yet obtained the board approvals required to execute the agreement.

A potential, but unintended result of the forced close out rule is the creation of a perverse incentive for a distressed customer to elect not to deliver margin in order to initiate close out proceedings early, protracting the recovery process for the broker-dealer. In such a situation, the broker dealer would need to implement closeout proceedings and incur legal expenses to recover losses from the customer, rather than providing the customer with the opportunity to settle the trade on the intended settlement date. While the broker-dealer would likely elect not to conduct future business with that customer, the problem created by the forced close out has the potential to create, rather than reduce, exposures.

One reasonable alternative to forced trade closeout could be an increase in the net capital charge from 100% to a higher percentage on uncollected and past due margin. This provides members with additional incentive to collect the past due margin, but does not force costly and messy legal proceedings. In addition, this would allow the member firm the flexibility to manage their credit risk on a case by case basis.

Another reasonable alternative to forced trade closeout would be to allow the member to not close out trades which have a relatively short number of days until settlement date - possibly 30 days or less. Other than TBAs, most trades in Covered Agency Securities settle within 30 days. Members would be better able to assess settlement risk on trades closer to settlement date.

The close-out decision should be a business decision concluded upon by members who are able to take into account all extenuating and relational circumstances and not driven solely by market movements and regulatory directive. Closing out trades should be the final option that members pursue against customers to remedy settlement failures. By accelerating the closeout to a point in time prior to settlement date, customers are not allowed the opportunity to deliver on the terms of the original agreement.

Covered Agency Securities Transactions by Non-FINRA members – Negative competitive consequences for FINRA member firms

Regional broker dealers that are organized as bank dealers and regulated by banking regulators will not be required to follow FINRA's margin rules as ultimately approved and implemented unless banking regulators subsequently enact similar margin collection requirements for Covered Agency Securities trades. Such bank dealers also do not submit trade data to TRACE[1].

Institutional customers prefer not to post initial or mark to market margin on Covered Agency Securities for obvious reasons. If a customer can purchase the same or similar security from either a member firm or non-member firm at a similar price, the customer will be inclined to purchase from the dealer that will not require them to execute an MSFTA or post margin. The implementation of this rule will clearly give bank dealers an advantage in selling Covered Agency Securities to institutional customers. Bank dealers should also be able to charge slightly higher prices for the added convenience of not requiring customers to post margin. These higher prices will also not be disclosed via TRACE, further limiting market transparency.

Another potential impact on FINRA members is that bank dealers, which would have the implicit advantage of allowing customers to not post margin, would be able to selectively increase trading exposures to the most credit worthy institutional customers to the detriment of their less credit worthy customers. This would move more credit-worthy customers from FINRA firms to non-FINRA firms. A gradual decline in FINRA members' market share and the credit quality of the customers which they serve would result. The unintended consequences of increasing bank dealers' customer credit quality, a decline in FINRA firm market share and a decline in FINRA firm customer credit quality should be of concern to FINRA.

One more disruptive impact to FINRA members is the business done with Non-Exempt counterparties. Why would any Non-Exempt Counterparty that is accustomed to settling transactions DVP ever trade with a FINRA member again if all FINRA members are required to collect maintenance margin and Non-FINRA dealers would not collect margin? Wouldn't all Non-Exempt Counterparties that are paying attention try move their business to bank dealers?

It would be in the best interest of FINRA member firms as a whole, and especially firms recognized as regional broker dealers, if FINRA would seriously engage bank regulators in discussions on the

[1] Omission from TRACE reporting is clearly an advantage that bank dealers have over FINRA members because price transparency on such trades is hidden from customers and the rest of the marketplace. However, since FINRA members do post their trades to TRACE, some measure of market transparency exists and bank dealers' advantages due to non-reporting is somewhat mitigated by the pricing disclosed on trades in similar bonds. Said another way, TRACE reporting helps to keep pricing by non-FINRA broker dealers near market even though their prices are not disseminated via TRACE. This self-limiting feature of TRACE has helped prevent a noticeable portion of bond business from shifting away from FINRA members to non-FINRA members as TRACE has been implemented over the past several years. No self-limiting feature will exist if bank dealers are not required to collect margin from customers.

topics of trade transparency and margin collection requirements and work in the interests of member firms to level the playing field. To believe that a more unequal playing field will not be exploited by those favored by the eventual changes to Rule 4210 is short-sighted and ultimately damaging to member firms.

Maintenance Margin / Non Exempt Accounts

The amendment to further require maintenance margin for Covered Agency Securities trades with any Non-Exempt Account, as currently proposed, over-reaches the requirement that the TMPG has enacted for primary dealers by asking customers for margin when there is potentially no material market risk and little-to-no negative equity in the trade. For member firms that do not transact any retail business, do not have any margin account customers and where the delivery and receipt of securities is almost exclusively DVP/RVP, this amendment creates a tremendous operational, record keeping and transactional burden and also adds transactional costs. For DVP member firms, the collection, tracking and processing of maintenance margin provides almost no settlement risk mitigation and will be unduly burdensome both operationally and from a relationship standpoint. Many more problems will be created than solved by implementing this part of the amendment on DVP / RVP accounts. We respectfully ask FINRA to leave the maintenance margin requirement in Rule 4210 unchanged, since the ultimate variation margin rule implemented will adequately cover exposure risks in Covered Agency Securities.

If, after considering the negative implications of the currently proposed maintenance margin rule amendment discussed above, FINRA still intends to implement maintenance margin, we ask FINRA to please consider two changes that would improve the current proposal. The first change to consider is to **only collect margin on sales to non-exempt accounts, exempting purchases from margin collection**. Forced margin collection on purchases from non-exempt accounts will alienate customers and not afford them any protection – asking a customer to pay us margin up front when they are selling us the security will not ever make sense to customers. The second change to consider is to **exempt smaller trades from maintenance margin**. Under the current proposal, a $2,000 margin call would result from a $100,000 trade - clearly collection of margin at such a small level would be a nuisance for all involved, provide immaterial risk coverage, and further add to compliance costs as discussed later. **We ask that trades under $1.5 million be exempted from the rule to materially reduce the number of such small and immaterial margin transfers**. Such a change would effectively make the minimum maintenance margin transfer amount $30,000 – still a very small relative amount.

Issues & Disruptions caused by Covered Agency Securities settlement terms migrating to T+1

In order to avoid potential margin posting requirements on Covered Agency Securities trades, most industry participants believe that settlement terms on specified pool trades will migrate from the next "good settlement date" for the specific product to T+1. The following are some issues to consider that may result from this general change in settlement terms:

Funding

Currently, dealers use the next "good settlement day" each month to settle MBS pool trades in each specific security type. Traders will buy for the next good settlement date and then during the days leading up to this good settlement date, will sell to customers for the same settlement date. The concept of good settlement date significantly lessens member firms' funding requirements, which have been negatively impacted by recent regulatory pressures. If settlement terms move to T+1, firms will need to hold more settled inventory positions to meet the needs of customer purchases and sales that require next day delivery. The increase in funding requirements will impact small to medium sized firms disproportionately as such firms typically trade small blocks of specified pools with their bank, credit union and S&L customers while larger firms are more focused on large block trades and the "true" TBA markets. Small blocks of specified pools are generally either funded by Tri-Party Repo, settlement bank loans or clearing broker loans due to the small size of each individual lot. DVP repo funding is generally limited to large block sizes. Most mid-sized dealers do not have access to the Tri-Party Repo funding market and will either increase funding with their settlement bank or be forced to reduce their participation in the MBS market or, worst case, exit the market altogether. In addition, a trend toward T+1 settlement will push dealers that utilize some sort of repo funding to shorter term or overnight repos whereas the current "good day" settlement practice permits longer term and in theory safer repos.

Liquidity and Pricing

Regional broker dealers are the primary providers of liquidity for fixed income security transactions for the 6,000 plus small to medium sized banks and savings banks and the 6,800 plus credit unions in the United States. Primary dealers typically do not move down market to serve this customer base and do not invest in a sales force with the relationships necessary to flourish in this customer footprint. If regional broker dealers are forced to limit their involvement in the MBS market due to the funding constraints as discussed above, liquidity for customers will be negatively impacted and the reduced availability of inventory will cause competitive pricing to suffer as well.

TBA Market Liquidity

If enacted, the proposal to require margin on specified pool trades beyond T+1 settlement would damage the liquidity in the mortgage TBA market as well. The proposal would certainly shift many trades in specified pools to T+1 and away from the current monthly "good settlement date" on which the majority of specified pool and TBAs settle. Doing so will materially reduce the volume of collateral available for delivery into TBA commitments that settle on the "good settlement date". The end result would be a less liquid TBA market, wider price swings, wider bid-ask spreads, and more fails. The only alternative to counteract the damage to the TBA market would be for dealers to increase their inventory of specified pools. This is not likely to happen given the deleveraging trend over the past few years and the risks and costs of carrying, hedging and funding such inventory to be held for the primary purpose of satisfying TBA commitments.

Fails

If settlement terms on specified pools generally move toward T+1, the industry should expect an increase in fails, especially in Investment Advisor accounts. Investment Advisors typically execute a trade and then follow up with the settlement account allocation details for such trade. Investment Advisors are not always able to provide settlement account allocation details on trade date and often new settlement accounts must be established by dealers to accommodate the settlement instructions provided by Investment Advisors. Specific settlement accounts protect end customers via DVP/RVP settlement. Any delays beyond trade date in communicating and processing such information will cause fails to occur that would not have occurred in a regular "good settlement date" scenario. Investment Advisors are also more likely than other accounts to move to T+1 since the proposed amendment looks through the IA to the beneficial owner of the account for payment of margin.

Post settlement factor updates

More trades settling T+1 will cause more trades to settle on "bad factors", which will increase post trade settlement money transfers in order to re-factor trades. Currently such operational and money transfer nuisances and risks are avoided by settling trades on the proper factors, generally on "good settlement date". Customer exposure to dealers will increase as factor adjustments result in payments being owed to customers. Currently, factor update payments owed to customers are treated as free credits when computing the required 15c3-3 deposit – an increase in these payables will further constrain member firm liquidity.

Custodial / Safekeeping Delays

Many types of customers pledge securities in their portfolio as collateral for various types of borrowing. When a customer sells a security which is pledged as collateral, the pledgee must notify the safekeeping or custodial agent before the pledged security can be released and ultimately delivered to the purchaser. Typically, this process will take more than one day to turn around and if all trades move to T+1, this type of operational slowdown at the Custodian will likely cause un-needed increases in fails as well. Currently it is not uncommon for a bank customer to ask for T+4 or T+5 settlement to allow time for pledge releases to occur at the safekeeping agent prior to delivery.

Proposed Margin Requirements and Rule 15c3-3

The proposed amendments to Rule 4210 will require member firms to collect both maintenance and variation margin from customers in situations where no previous requirement existed. In a future regulatory notice or other communication to FINRA members, FINRA should specifically address how they intend to treat customer funds or securities collected as maintenance and variation margin under the amended Rule 4210 for purposes of complying with Rule 15c3-3. We ask that FINRA carefully consider their interpretation to adequately protect customers, but not impair member firm liquidity.

Written Credit Approval Requirement for Counterparties trading Covered Agency Securities

What degree of documentation does FINRA expect member firms to collect and maintain when setting and monitoring counterparty credit risk limits for counterparties trading in Covered Agency Securities? Can the type of counterparty (regulated versus non-regulated) and the type of Covered Agency Security traded (long settle TBA versus regular way specified security) impact the depth and frequency of documentation required? We suggest that member firms be allowed to establish a reasonable, risk based approach to setting and monitoring their written counterparty risk limits.

Costs of complying with proposed Rule 4210 Amendments

Firms engaged in trading Covered Agency Securities will need to buy, build or lease a technology solution to compute and manage maintenance and variation margin requirements. For a regional broker, the cost of building or purchasing a system could easily reach the $150,000 to $350,000 range, possibly higher. Renting a reasonably priced 3rd party system can exceed $8,500 per month and become a permanent monthly expense. Also, one of the largest clearing banks, a TMPG member, is offering an all-in margin computation, collection and management solution for the price of $500 per month per MSFTA serviced. Regional dealers would typically need hundreds of MSFTAs serviced which, at such a price, would render such a service provider prohibitively expensive.

In addition, at least one full time employee will need to be retained to operate the system, communicate with sales reps and counterparties, monitor margin requirements, issue margin calls and, collect, pay or return margin. Another full time employee will need to be added to deal with the increased counterparty credit documentation requirements. Firms will also experience a period of outsized legal expenses during the MSFTA review and implementation phase as each Annex may be slightly different and require legal review. Additionally, firms will suffer from a lack of productivity during the MSFTA collection, review and execution process - educating customers on why this is necessary and explaining the process.

Closing

On behalf of Vining Sparks, I appreciate the opportunity to share our concerns, comments and questions on the proposed amendments to Rule 4210. We sincerely hope that FINRA will thoughtfully consider our requests and concerns as well as the concerns of other industry participants on this proposed amendment prior to finalizing it as this amendment will ultimately have significant and far-reaching impact on member firms and customers alike.

Sincerely,

Allen Riggs
Chief Financial Officer
Vining Sparks IBG, LP

Exhibit 5

Below is the text of the proposed rule change. Proposed new language is underlined; proposed deletions are in brackets.

* * * * *

4000. FINANCIAL AND OPERATIONAL RULES

* * * * *

4210. Margin Requirements

(a) Definitions

For purposes of this Rule, the following terms shall have the meanings specified below:

(1) through (12) No Change.

(13) The term “exempt account” means:

(A) No Change.

(B) any person that:

(i) has a net worth of at least $45 million and financial assets of at least $40 million for purposes of paragraphs (e)(2)(F)<u>,</u> [and] (e)(2)(G)[,] <u>and (e)(2)(H),</u> and

(ii) No Change.

(14) through (16) No Change.

(b) through (d) No Change.

(e) Exceptions to Rule

The foregoing requirements of this Rule are subject to the following exceptions:

(1) No Change.

(2) Exempted Securities, Non-equity Securities and Baskets

(A) through (E) No Change.

(F) Transactions with Exempt Accounts Involving Certain "Good Faith" Securities

Other than for Covered Agency Transactions as defined in paragraph (e)(2)(H) of this Rule, [O]on any "long" or "short" position resulting from a transaction involving exempted securities, mortgage related securities, or major foreign sovereign debt securities made for or with an "exempt account," no margin need be required and any marked to the market loss on such position need not be collected. However, the amount of any uncollected marked to the market loss shall be deducted in computing the member's net capital as provided in SEA Rule 15c3-1 and, if applicable, Rule 4110(a), subject to the limits provided in paragraph (e)(2)([H]I) [below] of this Rule.

Members shall maintain a written risk analysis methodology for assessing the amount of credit extended to exempt accounts pursuant to paragraph (e)(2)(F) of this Rule which shall be made available to FINRA upon request. The risk limit determination shall be made by a designated credit risk officer or credit risk committee in accordance with the member's written risk policies and procedures.

(G) Transactions With Exempt Accounts Involving Highly Rated Foreign Sovereign Debt Securities and Investment Grade Debt Securities

On any "long" or "short" position resulting from a transaction made for or with an "exempt account" (other than a position subject to paragraph (e)(2)(F) or (e)(2)(H) of this Rule), the margin to be maintained on highly rated foreign sovereign debt and investment grade debt securities shall be, in lieu of any greater requirements imposed under this Rule, (i) 0.5 percent of current market value in the case of highly rated foreign sovereign debt securities, and (ii) 3 percent of current market value in the case of all other investment grade debt securities. The member need not collect any such margin, provided the amount equal to the margin required shall be deducted in computing the member's net capital as provided in SEA Rule 15c3-1 and, if applicable, Rule 4110(a), subject to the limits provided in paragraph (e)(2)([H]I) [below] of this Rule.

Members shall maintain a written risk analysis methodology for assessing the amount of credit extended to exempt accounts pursuant to paragraph (e)(2)(G) of this Rule which shall be made available to FINRA upon request. The risk limit determination shall be made by a designated credit risk officer or credit risk committee in accordance with the member's written risk policies and procedures.

(H) Covered Agency Transactions

(i) Definitions

For purposes of paragraph (e)(2)(H) of this Rule:

a. The term "bilateral transaction" means a Covered Agency Transaction that is not cleared through a registered clearing agency as defined in paragraph (f)(2)(A)(xxviii) of this Rule.

b. The term "counterparty" means any person that enters into a Covered Agency Transaction with a member and includes a "customer" as defined in paragraph (a)(3) of this Rule.

c. The term "Covered Agency Transaction" means:

1. To Be Announced ("TBA") transactions, as defined in Rule 6710(u), inclusive of adjustable rate mortgage ("ARM") transactions, for which the difference between the trade date and contractual settlement date is greater than one business day;

2. Specified Pool Transactions, as defined in Rule 6710(x), for which the difference between the trade date and contractual settlement date is greater than one business day; and

3. Transactions in Collateralized Mortgage Obligations ("CMOs"), as defined in Rule 6710(dd), issued in conformity with a program of an Agency, as defined in Rule 6710(k), or a Government-Sponsored Enterprise, as defined in Rule 6710(n), for which the difference between the

trade date and contractual settlement date is greater than three business days.

d. The term "deficiency" means the amount of any required but uncollected maintenance margin and any required but uncollected mark to market loss.

e. The term "gross open position" means, with respect to Covered Agency Transactions, the amount of the absolute dollar value of all contracts entered into by a counterparty, in all CUSIPs; provided, however, that such amount shall be computed net of any settled position of the counterparty held at the member and deliverable under one or more of the counterparty's contracts with the member and which the counterparty intends to deliver.

f. The term "maintenance margin" means margin equal to 2 percent of the contract value of the net "long" or net "short" position, by CUSIP, with the counterparty.

g. The term "mark to market loss" means the counterparty's loss resulting from marking a Covered Agency Transaction to the market.

h. The term "mortgage banker" means an entity, however organized, that engages in the business of providing real estate financing collateralized by liens on such real estate.

i. The term “round robin” trade means any transaction or transactions resulting in equal and offsetting positions by one customer with two separate dealers for the purpose of eliminating a turnaround delivery obligation by the customer.

j. The term “standby” means contracts that are put options that trade OTC, as defined in paragraph (f)(2)(A)(xxvii) of this Rule, with initial and final confirmation procedures similar to those on forward transactions.

(ii) Margin Requirements for Covered Agency Transactions

a. All Covered Agency Transactions with any counterparty, regardless of the type of account to which booked, shall be subject to the provisions of paragraph (e)(2)(H) of this Rule, except:

1. with respect to Covered Agency Transactions with any counterparty that is a Federal banking agency, as defined in 12 U.S.C. 1813(z), central bank, multinational central bank, foreign sovereign, multilateral development bank, or the Bank for International Settlements, a member may elect not to apply the margin requirements specified

in paragraph (e)(2)(H) of this Rule provided the member makes a written risk limit determination for each such counterparty that the member shall enforce pursuant to paragraph (e)(2)(H)(ii)b.

b. A member that engages in Covered Agency Transactions with any counterparty shall make a determination in writing of a risk limit for each such counterparty that the member shall enforce. The risk limit determination shall be made by a designated credit risk officer or credit risk committee in accordance with the member's written risk policies and procedures.

c. The margin requirements specified in paragraph (e)(2)(H) of this Rule shall not apply to:

1. Covered Agency Transactions that are cleared through a registered clearing agency, as defined in paragraph (f)(2)(A)(xxviii) of this Rule, and are subject to the margin requirements of that clearing agency; and

2. any counterparty that has gross open positions in Covered Agency Transactions with the member amounting to $2.5 million or less in aggregate, if the original contractual settlement for all such transactions is in the month of the trade

date for such transactions or in the month succeeding the trade date for such transactions and the counterparty regularly settles its Covered Agency Transactions on a Delivery Versus Payment (“DVP”) basis or for “cash”; provided, however, that such exception from the margin requirements shall not apply to a counterparty that, in its transactions with the member, engages in dollar rolls, as defined in Rule 6710(z), or “round robin” trades, or that uses other financing techniques for its Covered Agency Transactions.

d. Transactions with Exempt Accounts: On any net “long” or net “short” position, by CUSIP, resulting from bilateral transactions with a counterparty that is an “exempt account” no maintenance margin shall be required. However, such transactions shall be marked to the market daily and the member shall collect any net mark to market loss, unless otherwise provided under paragraph (e)(2)(H)(ii)f. of this Rule. If the mark to market loss is not satisfied by the close of business on the next business day after the business day on which the mark to market loss arises, the member shall be required to deduct the amount of the mark to market loss from net capital as provided in

SEA Rule 15c3-1 until such time the mark to market loss is satisfied. If such mark to market loss is not satisfied within five business days from the date the loss was created, the member shall promptly liquidate positions to satisfy the mark to market loss, unless FINRA has specifically granted the member additional time. Members may treat mortgage bankers that use Covered Agency Transactions to hedge their pipeline of mortgage commitments as exempt accounts for purposes of paragraph (e)(2)(H) of this Rule.

e. Transactions with Non-Exempt Accounts: On any net "long" or net "short" position, by CUSIP, resulting from bilateral transactions with a counterparty that is not an "exempt account," maintenance margin, plus any net mark to market loss on such transactions, shall be required margin, and the member shall collect the deficiency, as defined in paragraph (e)(2)(H)(i)d. of this Rule, unless otherwise provided under paragraph (e)(2)(H)(ii)f. of this Rule. If the deficiency is not satisfied by the close of business on the next business day after the business day on which the deficiency arises, the member shall be required to deduct the amount of the deficiency from net capital as provided in SEA Rule 15c3-1 until such time the deficiency is satisfied. If such deficiency is not satisfied within five business days from the date the deficiency was created, the member shall promptly liquidate positions to satisfy the deficiency, unless FINRA has specifically granted the member additional time. No maintenance margin is required if the original contractual settlement for the Covered Agency Transaction is in the month of the trade date for such transaction or in the month succeeding the trade date for such transaction and the customer regularly settles its Covered Agency Transactions on a DVP basis or for "cash"; provided, however, that such exception from the required maintenance margin shall not apply to a non-exempt account that, in its transactions with the member, engages in dollar rolls, as defined in Rule 6710(z), or "round robin" trades, or that uses other financing techniques for its Covered Agency Transactions.

f. Any aforementioned deficiency, as set forth in paragraph (e)(2)(H)(ii)e. of this Rule, or mark to market losses, as set forth in paragraph (e)(2)(H)(ii)d. of this Rule, with a single counterparty shall not give rise to any margin requirement, and as such need not be collected or charged to net capital, if the aggregate of such amounts with such counterparty does not exceed $250,000 ("the de minimis transfer amount"). The full amount of the sum of the required maintenance margin and any mark to market loss must be collected when such sum exceeds the de minimis transfer amount.

g. Unrealized profits in one Covered Agency Transaction position may offset losses from other Covered Agency Transaction positions in the same counterparty's account and the amount of net unrealized profits may be used to reduce margin requirements. With respect to standbys, only profits (in-the-money amounts), if any, on "long" standbys shall be recognized.

([H]I) Limits on Net Capital Deductions [for Exempt Accounts]

[(i) Members shall maintain a written risk analysis methodology for assessing the amount of credit extended to exempt accounts pursuant to paragraph (e)(2)(F) and (e)(2)(G) which shall be made available to FINRA upon request.]

([ii]i) In the event that the net capital deductions taken by a member as a result of deficiencies or marked to the market losses incurred under paragraphs (e)(2)(F) and (e)(2)(G) of this Rule (exclusive of the percentage requirements established thereunder), plus any mark to market loss as set forth under paragraph (e)(2)(H)(ii)d. of this Rule and any deficiency as set forth under paragraph (e)(2)(H)(ii)e. of this Rule, and inclusive of all amounts excepted from margin requirements as set forth under paragraph (e)(2)(H)(ii)c.2. of this Rule or any de minimis transfer amount as set forth under paragraph (e)(2)(H)(ii)f. of this Rule, exceed:

a. [on] for any one account or group of commonly controlled accounts, 5 percent of the member's tentative net capital (as such term is defined in SEA Rule 15c3-1), or

b. [on] for all accounts combined, 25 percent of the member's tentative net capital (as such term is defined in SEA Rule 15c3-1), and,

c. such excess as calculated in paragraphs (e)(2)(I)(i)a. or b. of this Rule continues to exist[s] on the fifth business day after it was incurred,

the member shall give prompt written notice to FINRA and shall not enter into any new transaction(s) subject to the provisions of paragraphs (e)(2)(F), [or] (e)(2)(G) or (e)(2)(H) of this Rule that would result in an increase in the amount of such excess under, as applicable, [subparagraph (ii)] paragraph (e)(2)(I)(i) of this Rule.

* * * * *

(f) Other Provisions

(1) through (5) No Change.

(6) Time Within Which Margin or "Mark to Market" Must Be Obtained

The amount of margin or "mark to market" required by any provision of this Rule, other than that required under paragraph (e)(2)(H) of this Rule, shall be obtained as promptly as possible and in any event within 15 business days from the date such deficiency occurred, unless FINRA has specifically granted the member additional time.

(7) through (10) No Change.

(g) through (h) No Change.

• • • Supplementary Material: ---------------

.01 No Change.

.02 Monitoring Procedures. For purposes of paragraph (e)(2)(H)(ii)d. of this Rule, members shall adopt written procedures to monitor the mortgage banker's pipeline of mortgage loan commitments to assess whether the Covered Agency Transactions are being used for hedging purposes.

.03 Mark to Market Loss/Deficiency. For purposes of paragraph (e)(2)(H) of this Rule, to the extent a mark to market loss or deficiency is cured by subsequent market movements prior to the time the margin call must be met, the margin call need not be met and the position need not be liquidated; provided, however, if the mark to market loss or deficiency is not satisfied by the close of business on the next business day after the business day on which the mark to market loss or deficiency arises, the member shall be required to deduct the amount of the mark to market loss or deficiency from net capital as provided in SEA Rule 15c3-1 until such time the mark to market loss or deficiency is satisfied.

.04 Determination of Exempt Account. For purposes of paragraph (e)(2)(H) of this Rule, the determination of whether an account qualifies as an exempt account shall be made based upon the beneficial ownership of the account. Sub-accounts managed by an investment adviser, where the beneficial owner is other than the investment adviser, shall be margined individually.

.05 Risk Limit Determination.

(a) For purposes of any risk limit determination pursuant to paragraphs (e)(2)(F), (e)(2)(G) or (e)(2)(H) of this Rule:

(1) If a member engages in transactions with advisory clients of a registered investment adviser, the member may elect to make the risk limit determination at the investment adviser level, except with respect to any account or group of commonly controlled accounts whose assets managed by that investment adviser constitute more than 10 percent of the investment adviser's regulatory assets under management as reported on the investment adviser's most recent Form ADV;

(2) 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;

(3) The member may base the risk limit determination on consideration of all products involved in the member's business with the counterparty, provided the member makes a daily record of the counterparty's risk limit usage; and

(4) A member shall consider whether the margin required pursuant to this Rule is adequate with respect to a particular counterparty account or all its counterparty accounts and, where appropriate, increase such requirements.

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