Bond Dealers of America

1909 K Street NW, Ste 510
Washington, DC 20006
202.204.7900
www.bdamerica.org

May 14, 2021

Jennifer Piorko Mitchell
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, DC 20006-1506

In regard to FINRA Regulatory Notice 21-11

Dear Ms. Mitchell,

The Bond Dealers of America ("BDA") is pleased to provide comments on FINRA Regulatory Notice 21-11, "FINRA Requests Comment on Proposed Amendments to the Margin Rule Regarding When Issued and Other Extended Settlement Transactions" (the "Notice"). The Notice proposes additional changes to FINRA Rule 4210, "Margin Requirements" (the "Rule"), related to extended settlement trades. BDA is the only DC-based group exclusively representing the interests of securities dealers and banks focused on the US fixed income markets.

We maintain, as we have throughout our comments on this FINRA initiative, that the application of Rule 4210 to extended settlement trades, particularly in new-issue mortgage- and asset-backed securities ("MBS" and "ABS"), is anti-competitive and disadvantages smaller and regional firms. While we appreciate the flexibility provided by the element of the Rule permitting a capital charge in lieu of margin for certain transactions, that too is a flawed aspect of the Rule. While we recognize that this project has been in development for years, we urge FINRA to revisit the conceptual issue of attempting to impose margin requirements on delivery-versus-payment ("DVP") customers who have not executed margin agreements or Master Securities Forward Transaction Agreements ("MSFTA").

The Rule which would take effect in October based on the Notice would be particularly harmful for mid-size and regional broker-dealers who participate in the MBS market. MBS and ABS were the original impetus for the notion of applying Rule 4210 to extended settlement transactions because they tend to have long forward delivery times for new issues. In 2012 the Treasury Market Practices Group ("TPMG") recommended margining forward-settling agency MBS transactions. That recommendation eventually resulted in the extended settlement provisions of the Rule that are the subject of the Notice. The "covered agency transaction" provisions of the Notice and Rule address these issues directly.

The Rule as embodied in the Notice will have the effect of shrinking business for mid-size fixed income broker-dealers. It will have this effect because most customers who buy MBS and ABS that will be the focus of the Rule from mid-size dealers do so through DVP accounts not set up for margin and where collecting margin would be impossible or impractical. While the capital charge in lieu of margin would somewhat mitigate the inability to collect margin, smaller firms simply do not have the capital to support the margin requirements for all their customers. This is compounded by restrictions in the Rule limiting capital charges in lieu of margin. Other exemptions such as for "exempt accounts" also would fail to fully mitigate the limitations imposed by the Rule.

We recognize that the extended settlement proposal has been pending for years and is at a very late stage of development. However, BDA believes that as a matter of principle, a change in regulation should not disadvantage one subset of FINRA members relative to another. Since the Rule as embodied in the Notice violates this principle, we urge FINRA to withhold finalizing the Rule in its present proposed form and instead revisit key elements to ensure that the Rule addresses FINRA's goals without eroding the businesses of mid-size fixed income dealers.

Inability to collect margin from DVP customers and the questionable necessity of the requirement

It is not only impractical to collect margin from DVP customers. It is effectively impossible, particularly for firms that clear transactions through third-party clearing firms, including most regional and mid-size fixed income dealers. Clearing firms hold and maintain all customer cash and securities, among many other functions. The issue is that DVP customers are generally not set up with dedicated accounts to hold margin funds. When dealers request margin cash from DVP customers, the cash is deposited in customer cash accounts and is inaccessible to the dealer, even in the case of losses on the customer's related position. Unless the customer is pre-approved for margin trading or has executed a MSFTA, there is no provision for handling margin funds.

The MSFTA is a standardized, bilateral contract between parties engaged in when-issued, "To Be Announced" ("TBA"), and similar transactions that could involve delayed delivery of securities. The latest version of the MSFTA, produced after the TPMG margin recommendation was issued, includes provisions for two-way margining.[1] An executed MSFTA provides a means for a dealer to collect and maintain margin for extended settlement transactions in the limited products covered by the agreement without the customer being a full-fledged margin account. However, many institutional investors are reluctant to execute MSFTAs with smaller broker-dealers since they often do not have access to bank liquidity, may not have credit ratings, and similar perceived concerns. Actual margin accounts often come with burdensome application and documentation requirements, and if customers do not intend to trade securities on margin, there is little reason to have margin agreements with multiple dealers. In practice, the majority of mid-size MBS/ABS broker-dealers' customers have not executed margin agreements or MSFTAs, and that is unlikely to change. That means in practice, mid-size MBS dealers will have no choice but to take capital charges in lieu of margin for a majority of their customers.

Compounding the Rule's imposition of a requirement that is difficult, if not impossible, for many dealers to satisfy is the questionable necessity of the requirement. DVP customers are generally large, sophisticated institutions that are extremely unlikely to default on their obligations in any extended settlement transactions.

Limitations of the capital charge provision

The Rule permits dealers to take a capital charge in lieu of margin for certain when-issued transactions. This flexibility in the Rule is important. Without it, the Rule would be completely unworkable for many dealers and transactions. However, capital charges in lieu of margin have limitations. The Rule limits a dealer's capital charges in lieu of margin to 25 percent of tentative net capital ("TNC") overall and five percent of TNC per customer. For mid-size dealers who effectively cannot collect margin from a majority

[1] SIFMA, "Guidance Notes to the Master Securities Forward Transaction Agreement," December 2012, www.sifma.org/wp-content/uploads/2017/08/Guidance-NotestoDecember-2012MSFTA.pdf.

of their customers and who must rely on capital charges to continue to execute extended settlement transactions, 25 percent is too little. For huge dealers with billions in capital, the 25 percent limit is too big, allowing large firms to waive margin requirements when not necessary.

Most important, smaller broker-dealers simply do not have the huge capital cushions that the bulge bracket firms do. Not only is their capital base smaller, but the likelihood that they will not be able to collect margin from extended settlement customers means they will rely more heavily on the capital charge provision, despite their smaller capital base.

Moreover, the capital charges to be incurred in lieu of margin are so much larger relative to the size of the liability than for other exposures. Dealer capital charges tend to be a fraction of the risk exposure and vary based on circumstances. For many fixed-income products held on a dealer's balance sheet, for example, the effective capital charge might be as much as 5-6 percent of the exposure. But under the Rule, dealers must pledge capital to cover the entire amount of margin that would otherwise be required of customers.

Additionally, the capital charge provision of the Rule would impose demands on firms' capital in distressed market conditions where liquidity is thin, prices are volatile, and capital is needed to provide customer liquidity. This means the Rule would contribute to a distressed market like we experienced in February and March 2020 in a pro-cyclical fashion. Precious capital needed to take customer sales into inventory would be otherwise tied up covering extended settlement positions. While we appreciate that a capital charge in lieu of margin is available to dealers under the Rule, limiting dealers' ability to provide liquidity in difficult market conditions will be an unintended effect of the Rule if implemented as proposed.

Finally, the Rule provides a process for dealers in circumstances where capital charges in lieu of margin exceed the allowed thresholds of 25 percent overall or five percent per customer. This process is generally punitive and may not be in the best interest of customers. Paragraph (e)(2)(I) of the Rule specifies that if capital charges in lieu of margin exceed regulatory limits for five days, the firm must notify FINRA and stop customer transactions that would lead to further capital charges. Limiting options for investors is not the best way to police restrictions in the Rule. Instead, we urge FINRA to adopt a more cooperative, collaborative process for resolving issues of margin and related capital charges which does not automatically force dealers to stop providing service to customers.

<u>New issue municipal securities</u>

The Rule exempts certain when-issued, extended settlement transactions in municipal securities from margin requirements if bonds are scheduled to be delivered by the issuer by the 42nd calendar day after the trade date. We appreciate this specific exclusion for municipal securities. We understand from Footnote 12 of the Notice that the 42-day period stems from a SEC interpretation of a provision of the Net Capital Rule. While we believe the 42-day exception would be helpful to municipal issuers and dealers, we request that FINRA extend that period that to one year.

In 2017 Congress enacted the Tax Cuts and Jobs Act ("TCJA", P.L. 115-97). One provision of that law prohibited a type of financing popular with municipal securities issuers known as advance refundings beginning in 2018. Many tax-exempt municipal securities are issued with call options for issuers that provide a means to refinance outstanding bonds when interest rates fall. An advance refunding occurs when an issuer sells tax-exempt refunding bonds more than three months before the old, high interest bonds become callable. The TCJA specifies that tax-exempt advance refundings of municipal bonds are no longer permitted.

As a result, some municipal issuers have taken to issuing refunding bonds on a forward basis, with the delivery date timed to coincide with the call date on the old bonds. Using forward delivery, state and local governments can engage in money-saving refinancings before the call dates on their old bonds without violating the statutory prohibition on advance refundings.

Forward-delivery refunding transactions have become very popular since 2018. Last month the state of California priced a $1.1 billion refunding bond for delivery in September, more than five months after pricing, the biggest municipal forward transaction since the TCJA was enacted.[2] Some issuers have priced refunding transactions with delivery dates as long as one year or longer.

We examined 4,516 municipal securities issuances priced between January 1, 2021 and May 11, 2021 representing approximately $157 billion par amount. Delivery times ranged from zero days to 422 days. 306 issuances had delivery times greater than 42 days, nearly seven percent of the sample. The average time to delivery for the entire sample was just over 25 days, and the median was 22 days. Of those transactions with delivery times greater than 42 days, the average was 69 days, and the median was 49 days. Clearly, there is a significant volume of municipal new issues that would not be helped by the 42-day when-issued exception. We would be happy to share our data with FINRA staff.

With fiscal pressures imposed by the pandemic, state and local governments are relying on refunding transactions more than ever. Imposing margin requirements on investors in these transactions would ultimately result in those costs being borne by issuers, eating into the savings provided by the refunding. This would happen because the costs of margin imposed on customers or dealers or both ultimately will be reflected in capital or issuance costs for the issuer. In order to provide as much financial flexibility to issuers as possible, we ask FINRA to extend the 42-day exception for municipal securities to 365 days.

<u>When-issued government securities</u>

The Rule also provides an exception from margin requirements for when-issued government securities. Under the Rule, government securities include "obligations…issued or guaranteed as to principal or interest by the United States Government or by corporations in which the United States has a direct or indirect interest." (Paragraph (e)(2)(A) of the Rule) The Rule specifies that when-issued government securities which are intended to settle by the 14th calendar day after execution are exempt from margin requirements. (Paragraph (f)(3)(B) of the proposed Rule) This exception is welcome. However, some issuers whose debt securities are included in this exception, such as the Federal Home Loan Bank System and the Farm Credit System, conduct issuances where the time to delivery may be as long as 30 days. Given that these issuers are government-guaranteed and underwriting their issuance imposes relatively less risk on dealers, we request that FINRA extend the 14-day exception for Treasury and agency securities to 30 days.

[2] Romy Varghese, "California Sets Record Forward-Delivery Sale," *Bloomberg Daily Brief: Muni*, April 16, 2021.

Summary

The application of Rule 4210 to extended settlement transactions, despite being the subject of nearly ten years of debate and discussion, is unfortunately not yet ready for implementation. The reason is that the Rule as written in the Notice for October implementation continues to disadvantage mid-size and regional firms, especially those involved in the markets where extended delivery times for new-issue securities are common. The Rule would harm mid-size firms because the majority of those firms' extended settlement customers do not have margin accounts or MSFTAs, making it virtually impossible to collect and maintain margin.

The provision to permit a capital charge in lieu of margin for certain when-issued transactions helps but does not solve mid-size firms' problems with the Rule. The limitations on the capital charge provisions are too low. But even more important, mid-size dealers simply have less capital than larger firms, and this Rule places more demand on regional firms' capital than on that of bulge bracket firms.

Moreover, nine years after the TPMG first raised the prospect of margin for MBS and ABS new issues with extended settlement times, FINRA has been forced to extend the compliance implementation deadline numerous times, most recently in January, to accommodate continued changes to the Rule. With implementation less than six months away, FINRA is still proposing significant amendments as embodied in the Notice and the covered agency transaction proposal which FINRA recently sent to the SEC, signifying that the Rule remains flawed.

We agree. Despite FINRA's continued willingness to adapt the Rule to dealer concerns, it remains in a form which would negatively affect regional and mid-size firms relative to some of their competitors. Moreover, since the TPMG first suggested that margin be collected on extended settlement transactions, that market has been tested by some of the most extreme conditions imaginable during the early days of the pandemic, without the adverse consequences the Rule purports to address, calling into question the necessity of many of the new requirements. For that reason, we ask FINRA to broadly rethink the Rule conceptually and to further extend implementation until the deficiencies in the Rule are corrected.

Sincerely,

Michael Decker
Senior Vice President