

harmonization among Exchange, BZX, BYX, and EDGA rules of similar purpose.

*(C) Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received From Members, Participants or Others*

The Exchange has neither solicited nor received written comments on the proposed rule change.

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

The Exchange has designated this rule filing as non-controversial under Section 19(b)(3)(A) of the Act<sup>17</sup> and paragraph (f)(6) of Rule 19b-4 thereunder.<sup>18</sup> The proposed rule change effects a change that (A) does not significantly affect the protection of investors or the public interest; (B) does not impose any significant burden on competition; and (C) by its terms, does not become operative for 30 days after the date of the filing, or such shorter time as the Commission may designate if consistent with the protection of investors and the public interest; provided that the self-regulatory organization has given the Commission written notice of its intent to file the proposed rule change, along with a brief description and text of the proposed rule change, at least five business days prior to the date of filing of the proposed rule change, or such shorter time as designated by the Commission.

At any time within 60 days of the filing of the proposed rule change, the Commission may summarily temporarily suspend such rule change if it appears to the Commission that such action is: (1) Necessary or appropriate in the public interest; (2) for the protection of investors; or (3) otherwise in furtherance of the purposes of the Act. If the Commission takes such action, the Commission shall institute proceedings to determine whether the proposed rule should be approved or disapproved.

**IV. Solicitation of Comments**

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposal 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 email to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File No. SR-EDGX-2015-44 on the subject line.

*Paper comments*

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

All submissions should refer to File No. SR-EDGX-2015-44. This file number should be included on the subject line if email 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 Web site (<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 Web site 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 10:00 a.m. and 3:00 p.m. Copies of such filing will also be available for inspection and copying at the principal office of the Exchange. 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 No. SR-EDGX-2015-44 and should be submitted on or before November 10, 2015.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>19</sup>

**Robert W. Errett,**

*Deputy Secretary.*

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**SECURITIES AND EXCHANGE COMMISSION**

[Release No. 34-76148; 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**

October 14, 2015.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on October 6, 2015, 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. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change**

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 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 Web site at <http://www.finra.org>, at the principal office of FINRA and at the Commission's Public Reference Room.

<sup>17</sup> 15 U.S.C. 78s(b)(3)(A).

<sup>18</sup> 17 CFR 240.19b-4.

<sup>19</sup> 17 CFR 200.30-3(a)(12).

<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

## 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,<sup>3</sup> inclusive of ARM transactions, (2) Specified Pool Transactions,<sup>4</sup> and (3) transactions in CMOs,<sup>5</sup> issued in conformity with a program of an agency<sup>6</sup> or GSE,<sup>7</sup> with

<sup>3</sup> 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).

<sup>4</sup> 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.

<sup>5</sup> 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").

<sup>6</sup> 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."

<sup>7</sup> FINRA Rule 6710(n) defines GSE to have the meaning set forth in 2 U.S.C. 622(8). Under 2 U.S.C.

forward settlement dates, as further defined herein<sup>8</sup> (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.<sup>9</sup> 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.<sup>10</sup>

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.<sup>11</sup> The TMPG Report noted

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.

<sup>8</sup> See Item IIA.1(A)(1) *infra*.

<sup>9</sup> 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/epv/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](http://www.sec.gov/news/studies/mortgagebacked.htm#footbody_36)>.

<sup>10</sup> See Treasury Market Practices Group ("TMPG"), Margining in Agency MBS Trading, November 2012, available at: <[http://www.newyorkfed.org/tmpg/margining\\_tmpg\\_11142012.pdf](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.

<sup>11</sup> 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](http://www.newyorkfed.org/tmpg/bestpractices_040414.pdf)>.

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."<sup>12</sup> 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."<sup>13</sup>

The TMPG best practices are recommendations and as such currently are not rule requirements.<sup>14</sup> 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.<sup>15</sup> 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 rule change, and (f)(6),<sup>16</sup> and to add to

<sup>12</sup> See TMPG Report.

<sup>13</sup> See note 12 *supra*.

<sup>14</sup> 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.

<sup>15</sup> 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.

<sup>16</sup> Paragraph (e)(2) of Rule 4210, broadly, addresses margin requirements as to exempted

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.<sup>17</sup> FINRA sought comment on the proposal in a *Regulatory Notice* (the “Notice”).<sup>18</sup> As discussed further in Item II.C 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 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.

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.

<sup>17</sup> 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>>.

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

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

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.<sup>27</sup> As further discussed in 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

<sup>19</sup> See note 3 *supra*.

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

<sup>21</sup> See note 4 *supra*.

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

<sup>23</sup> See note 5 *supra*.

<sup>24</sup> See note 6 *supra*.

<sup>25</sup> See note 7 *supra*.

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

<sup>27</sup> 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 17 *supra*. The proposed definition of Covered Agency Transactions would cover these types of products as they are commonly understood to the industry.

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;<sup>28</sup>
- 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;<sup>29</sup>
- The term “deficiency” means the amount of any required but uncollected maintenance margin and any required but uncollected mark to market loss;<sup>30</sup>
- 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;<sup>31</sup>
- 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;<sup>32</sup>
- The term “mark to market loss” means the counterparty’s loss resulting from marking a Covered Agency Transaction to the market;<sup>33</sup>
- 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;<sup>34</sup>
- The term “round robin” trade means any transaction or transactions

<sup>28</sup> 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).

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

<sup>30</sup> See proposed FINRA Rule 4210(e)(2)(H)(i)d. in Exhibit 5.

<sup>31</sup> See proposed FINRA Rule 4210(e)(2)(H)(i)e. in Exhibit 5.

<sup>32</sup> See proposed FINRA Rule 4210(e)(2)(H)(i)f. in Exhibit 5.

<sup>33</sup> See proposed FINRA Rule 4210(e)(2)(H)(i)g. in Exhibit 5.

<sup>34</sup> See proposed FINRA Rule 4210(e)(2)(H)(i)h. in Exhibit 5.

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;<sup>35</sup> 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.<sup>36</sup>

### (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,<sup>37</sup> 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,<sup>38</sup> 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.<sup>39</sup>

- *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.<sup>40</sup> 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*.<sup>41</sup> The new Supplementary

Material provides that, for purposes of any risk limit determination pursuant to paragraphs (e)(2)(F), (e)(2)(G)<sup>42</sup> 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;<sup>43</sup>

- 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;<sup>44</sup>

- 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;<sup>45</sup> 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.<sup>46</sup>

- *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),<sup>47</sup> and are subject

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

<sup>36</sup> See proposed FINRA Rule 4210(e)(2)(H)(i). 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).

<sup>37</sup> 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.

<sup>38</sup> 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.

<sup>39</sup> 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 II.C.7 *infra*.

<sup>40</sup> 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.

<sup>41</sup> 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*.

<sup>42</sup> 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.

<sup>43</sup> See proposed FINRA Rule 4210.05(a)(1) in Exhibit 5.

<sup>44</sup> See proposed FINRA Rule 4210.05(a)(2) in Exhibit 5.

<sup>45</sup> See proposed FINRA Rule 4210.05(a)(3) in Exhibit 5.

<sup>46</sup> See proposed FINRA Rule 4210.05(a)(4) in Exhibit 5.

<sup>47</sup> See note 28 *supra*.

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),<sup>48</sup> or round robin trades, or that uses other financing techniques for its Covered Agency Transactions.

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.<sup>49</sup>

#### • *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.<sup>50</sup> 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.<sup>51</sup> 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.<sup>52</sup> 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.<sup>53</sup> Under the rule, members may treat mortgage bankers that use Covered Agency Transactions to hedge their pipeline of mortgage commitments as

<sup>50</sup> 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 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*.

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

<sup>52</sup> 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.

<sup>53</sup> 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).

exempt accounts for purposes of paragraph (e)(2)(H) of this Rule.<sup>54</sup>

#### • *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,<sup>55</sup> 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.<sup>56</sup> 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

<sup>54</sup> 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).

<sup>55</sup> 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.

<sup>56</sup> 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 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.

<sup>48</sup> 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.

<sup>49</sup> 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.

satisfy the deficiency, unless FINRA has specifically granted the member additional time.<sup>57</sup>

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 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)., or that uses other financing techniques for its Covered Agency Transactions.<sup>58</sup>

• *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.<sup>59</sup> 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 *Notice*.<sup>60</sup>

• *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 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.”<sup>61</sup> 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

<sup>57</sup> See notes 53 and 56 *supra*.

<sup>58</sup> 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*.

<sup>59</sup> See Item II.C.3 for further discussion.

<sup>60</sup> 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*.

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

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.<sup>62</sup>

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),<sup>63</sup> or
- for all accounts combined, 25 percent of the member’s tentative net capital (as such term is defined in SEA Rule 15c3–1),<sup>64</sup> 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,<sup>65</sup> 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.

## 2. Statutory Basis

FINRA believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,<sup>66</sup> 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 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<sup>67</sup> 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.<sup>68</sup> To the extent that the proposed

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

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

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

<sup>66</sup> 15 U.S.C. 78o–3(b)(6).

<sup>67</sup> All references to commenters are to commenters as listed in Exhibit 2b and as further discussed in Item ILC of this filing.

<sup>68</sup> 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/marginmbs.pdf>> see also TMPG Report.

<sup>62</sup> 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.



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)<sup>69</sup>—in repurchase agreements, securities lending and derivatives markets.<sup>70</sup> 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.<sup>71</sup>

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.<sup>72</sup>

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 dealer-to-customer trades.<sup>73</sup> 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.<sup>74</sup> 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 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.<sup>75</sup> 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,<sup>76</sup> or as to whether the trade is a specified financing trade (we note that, other than 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.<sup>77</sup>

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.

<sup>73</sup> 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](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.

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

<sup>75</sup> See TMPG Meeting Minutes, June 25, 2014, available at: [http://www.newyorkfed.org/tmpg/june\\_minutes\\_2014.pdf](http://www.newyorkfed.org/tmpg/june_minutes_2014.pdf).

<sup>76</sup> 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.

<sup>77</sup> 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

<sup>69</sup> Public Law 111–203, 124 Stat. 1376 (2010).

<sup>70</sup> 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>.

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

<sup>72</sup> 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



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 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-margining, 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 TMFG 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,<sup>78</sup> 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.<sup>79</sup> 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 specified contractual settlement terms that are elements of the exception are not available.<sup>80</sup>

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

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

<sup>80</sup> 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.

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).<sup>81</sup> 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.

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.<sup>82</sup> 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.<sup>83</sup>

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.<sup>84</sup>

#### (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. 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 million) and the mean (median) difference between the trade date and contractual settlement date is 25.2 days (20 days).<sup>85</sup> 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.<sup>86</sup> 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.<sup>87</sup>

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

<sup>81</sup> 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.

<sup>82</sup> See proposed FINRA Rule 4210(e)(2)(H)(ii)d. and Rule 4210.02 in Exhibit 5.

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

<sup>84</sup> See note 54 *supra*.

<sup>85</sup> 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).

<sup>86</sup> FINRA understands that a significant portion of the interdealer trades go through MBSD.

<sup>87</sup> 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.

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,<sup>88</sup> 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 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 billion) 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.<sup>89</sup> 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.<sup>90</sup>

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.<sup>91</sup> 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.

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.<sup>92</sup> 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.<sup>93</sup>

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 members.<sup>94</sup> 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.<sup>95</sup> 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

<sup>89</sup> Ambassador, Baird, BB&T, BDA, Brean, Clarke, Duncan-Williams, FirstSouthwest, Mischler, Pershing, Shearman, SIFMA and Simmons.

<sup>90</sup> Baird, Baum, BDA, Clarke and Sandler.

<sup>91</sup> Counterparty credit risk increases axiomatically during volatile market conditions, as recently experienced in the TBA market in the summer of 2011.

<sup>92</sup> Ambassador, Baum, BDA and Coastal.

<sup>93</sup> BB&T.

<sup>94</sup> 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).

<sup>95</sup> MBA and MetLife.

<sup>88</sup> See note 81 *supra* for the margin calculation methodology.

affect trading volume in the futures market, a finding consistent with expectations from theory.<sup>96</sup> More recently, other researchers have provided evidence from a foreign derivatives market that margin has no impact on trading volume.<sup>97</sup> 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.

### 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<sup>98</sup> in the TBA market across two periods with different interest rate characteristics, relying on Deutsche Bank's TBA index.<sup>99</sup> 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.<sup>100</sup> Therefore, a margin obligation for broker-dealers 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 I.I.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.<sup>101</sup> 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.<sup>102</sup> 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.

### 5. Alternatives Considered

FINRA considered a number of alternatives in developing the proposed rule change. As discussed further in Item I.I.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 I.I.C, FINRA determined to retain the specified settlement cycles in the

<sup>96</sup> 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).

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

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

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

<sup>100</sup> 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.

<sup>101</sup> Ambassador, Baird, BB&T, BDA, Brean, Clarke, Duncan-Williams, FirstSouthwest, Mischler, Pershing, Shearman, SIFMA and Simmons.

<sup>102</sup> See note 10 supra.

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<sup>103</sup> 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,<sup>104</sup> 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<sup>105</sup> for which the difference between the trade date and contractual settlement date is greater than one business day; and (3) transactions in CMOs,<sup>106</sup> issued in conformity with a program of an Agency or GSE, for which the difference between the trade date and contractual settlement date is greater than three business days.<sup>107</sup> 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.<sup>108</sup> 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.<sup>109</sup> 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.<sup>110</sup> For example, some commenters suggested that by imposing requirements solely on TBA transactions, and eliminating Specified Pool Transactions, 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.<sup>111</sup> 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.<sup>112</sup>

As discussed earlier, in response to commenter concerns, FINRA has engaged in extensive discussions with market participants and other

forward settling transactions, as discussed further below.

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

<sup>109</sup> 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.

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

<sup>111</sup> Ambassador, Baum, BDA, Coastal, FirstSouthwest and SIFMA.

<sup>112</sup> Baird, BB&T, BDA, FirstSouthwest, ICI, MetLife, PIMCO and SIFMA.

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<sup>113</sup> in Covered Agency 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.<sup>114</sup> 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),<sup>115</sup> or round robin trades,<sup>116</sup> or that uses other financing techniques for its Covered Agency Transactions.<sup>117</sup>

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

<sup>113</sup> 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 under one or more of the counterparty's contracts with the member and which the counterparty intends to deliver.

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

<sup>115</sup> See note 48 *supra*.

<sup>116</sup> The term "round robin" trade is defined in proposed FINRA Rule 4210(e)(2)(H)(i)j. 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.

<sup>117</sup> 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.

<sup>103</sup> All references to commenters are to the commenters as listed in Exhibit 2b.

<sup>104</sup> See note 3 *supra*.

<sup>105</sup> See note 4 *supra*.

<sup>106</sup> See note 5 *supra*.

<sup>107</sup> 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

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 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),<sup>118</sup> 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.<sup>119</sup> 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,<sup>120</sup> 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.<sup>121</sup> 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.

<sup>118</sup> See Item II.B.3 of this filing.

<sup>119</sup> 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.

<sup>120</sup> Based on analyses of TRAC 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.

<sup>121</sup> 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.

## 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.<sup>122</sup> 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.<sup>123</sup> 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.<sup>124</sup> 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.<sup>125</sup>

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<sup>126</sup> value of the net long or net short position, by CUSIP, with the counterparty.<sup>127</sup> However, no maintenance margin would be required if the original contractual settlement for the Covered Agency Transaction is in

<sup>122</sup> AIA, Clarke, Credit Suisse, Shearman, SIFMA and SIFMA AMG.

<sup>123</sup> AMG, BDA, Clarke, FIF, FirstSouthwest, Sandler and SIFMA.

<sup>124</sup> Baird, BB&T, Clarke, Duncan-Williams, Shearman and Vining Sparks.

<sup>125</sup> MountainView and Pershing.

<sup>126</sup> 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.

<sup>127</sup> 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.

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 requirements. Commenters opposed maintenance margin because of its impact on non-exempt accounts.<sup>128</sup> 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.<sup>129</sup> Further, FINRA notes that two percent aligns with the standard haircut for reverse repo transactions in FNMA, GNMA and FHLMC mortgage pass-through certificates<sup>130</sup> and approximates the amount charged by MBSD. The two percent amount also approximates the initial margin charged by the CME Group for corresponding products.<sup>131</sup> Accordingly, the two percent amount

<sup>128</sup> 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.

<sup>129</sup> 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.

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

<sup>131</sup> 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](http://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](http://www.cmegroup.com/trading/interest-rates/us-treasury/30-year-us-treasury-bond_performance_bonds.html)> (for U.S. Treasury Bond contracts).

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.

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.

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.<sup>132</sup> Some commenters proposed alternative amounts or suggested tiering the amount.<sup>133</sup> 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.<sup>134</sup> Commenters suggested that capital charges should not be required below

the threshold amount, or that the de minimis transfer provisions should be eliminated altogether.<sup>135</sup>

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 *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.<sup>136</sup> As explained in the *Notice*, 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 amount.<sup>137</sup>

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

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.<sup>140</sup> 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.<sup>141</sup> FINRA believes

<sup>138</sup> BB&T, FIF, Duncan-Williams and SIFMA.

<sup>139</sup> Pershing.

<sup>140</sup> 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.

<sup>141</sup> 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

Continued

<sup>132</sup> AII, Baird, BDA, FIF, Shearman and SIFMA.

<sup>133</sup> Clarke, Crescent, ICI and MountainView.

<sup>134</sup> Clarke, Sandler and SIFMA.

<sup>135</sup> BDA and Sandler.

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

<sup>137</sup> 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.



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<sup>142</sup> 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.

#### 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.<sup>143</sup> 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

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.

<sup>142</sup> See note 40 *supra*.

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

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.

#### 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.<sup>144</sup>

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.<sup>145</sup>

#### 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.<sup>146</sup> The Federal Home Loan Banks (FHLB) requested exemption from the requirements on grounds of the low counterparty risk that they believe they present.<sup>147</sup> 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.<sup>148</sup>

In response, as noted earlier<sup>149</sup> 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),<sup>150</sup> 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

<sup>145</sup> See proposed FINRA Rule 4210(e)(2)(I) in Exhibit 5.

<sup>146</sup> SIFMA.

<sup>147</sup> FHLB.

<sup>148</sup> SIFMA and SIFMA AMG.

<sup>149</sup> See note 39 *supra*.

<sup>150</sup> See note 38 *supra*.

<sup>144</sup> BB&T, BDA, FirstSouthwest, Mischler, Sandler, SIFMA and SIFMA AMG.

the “Volcker Rules” as adopted in January, 2014.<sup>151</sup> 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”).<sup>152</sup> 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.

#### 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.<sup>153</sup> 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.<sup>154</sup>

In response, FINRA believes that the five-day period as proposed is appropriate in view of the potential counterparty risk in the TBA market.<sup>155</sup> 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.<sup>156</sup> 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.<sup>157</sup> 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.<sup>158</sup> 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.

##### (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.<sup>159</sup> 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.<sup>160</sup>

##### (c) Margining of Fails

Three commenters sought clarification as to whether members would be required to margin fails to deliver.<sup>161</sup> 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 Transaction Agreement (MSFTA).<sup>162</sup> Some commenters suggested the proposal should impose limits with respect to types of collateral.<sup>163</sup> 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,<sup>164</sup> FINRA should enhance protection of the margin that customers post by requiring that members hold the margin through tri-party custodial arrangements.<sup>165</sup> 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

<sup>151</sup> 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).

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

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

<sup>154</sup> SIFMA.

<sup>155</sup> 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).

<sup>156</sup> See notes 52, 53 and 56 *supra*.

<sup>157</sup> See proposed FINRA Rule 4210(e)(2)(H)(ii)d.

<sup>158</sup> Brevan.

<sup>159</sup> Sandler.

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

<sup>161</sup> Pershing, Sandler and SIFMA.

<sup>162</sup> AII, Clarke, FIF and SIFMA.

<sup>163</sup> BB&T and Duncan-Williams.

<sup>164</sup> 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).

<sup>165</sup> Brevan.

use of tri-party custodial arrangements.<sup>166</sup>

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.

#### (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.<sup>167</sup> 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.<sup>168</sup> 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 pricing and a calculation methodology for the TBA market.<sup>169</sup> 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 Web site makes available extensive TRACE data and

other market data for use by the public.<sup>170</sup>

#### (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.<sup>171</sup> 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.<sup>172</sup> 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.<sup>173</sup>

### 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

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

<sup>171</sup> Vining Sparks.

<sup>172</sup> AII, BB&T, Credit Suisse, FIF, ICI and Pershing.

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

- Send an email to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-FINRA-2015-036 on the subject line.

#### Paper Comments

- Send paper comments in triplicate to 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 email 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 Web site (<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 Web site 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 November 10, 2015.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>174</sup>

**Robert W. Errett,**

*Deputy Secretary.*

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<sup>166</sup> ICI.

<sup>167</sup> SIFMA.

<sup>168</sup> Shearman.

<sup>169</sup> BB&T.

<sup>174</sup> 17 CFR 200.30-3(a)(12).