

# FINANCIAL INFORMATION FORUM

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New York, New York 10004

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212-422-8568

March 28, 2014

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

Re: Regulatory Notice 14-02 – FINRA Request for Comment on Proposed Amendments to FINRA Rule 4210 for Transactions in the TBA Market

Dear Ms. Asquith,

The Financial Information Forum (FIF)<sup>1</sup> would like to take this opportunity to comment on Regulatory Notice 14-02 – FINRA Request for Comment on Proposed Amendments to FINRA Rule 4210 for Transactions in the TBA Market (“MBS Margining Proposal”). FIF recommends that FINRA consider the following modifications to their MBS Margining Proposal:

- Exempt retail and advisory accounts from MBS Margining Proposal requirements
- Match TMPG recommendations to reduce costs and complexity
  - Eliminate maintenance margining requirement thereby eliminating the need for exempt/non-exempt accounts
  - Eliminate requirement to margin at sub-account level
- Account for current business practices
  - Leverage MSFTA form to the greatest extent possible
  - Address the impact of failed trades on margin requirements
- Phase implementation of rule to initially require margining on dealer activity
  - Leverage MBSD for institutional clients
  - Address institutional client complexities (e.g., grace period)

Each of these recommendations is discussed more fully below.

## **Exempt Retail and Advisory Accounts from MBS Margining Proposal**

In addition to FINRA members, the MBS Margining Proposal will impact every entity that transacts with FINRA members in MBS securities. FIF believes that the costs associated with applying the proposal

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<sup>1</sup> FIF ([www.fif.com](http://www.fif.com)) was formed in 1996 to provide a centralized source of information on the implementation issues that impact the financial technology industry across the order lifecycle. Our participants include trading and back office service bureaus, broker-dealers, market data vendors and exchanges. Through topic-oriented working groups, FIF participants focus on critical issues and productive solutions to technology developments, regulatory initiatives, and other industry changes.

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requirements to retail<sup>2</sup> and advisory accounts significantly outweigh the benefits of their inclusion in the rule. FIF believes that retail and advisory accounts represent a small percentage of MBS activity and do not pose the kind of counterparty and systemic risk concerns that the MBS Margining Proposal and Treasury Market Practice Group (TMPG) recommendations are aiming to mitigate. However, introducing the MBS Margining Proposal into these accounts would be a tremendous operational challenge with significant costs given that there are generally no systems currently in place to manage and monitor this functionality for these types of accounts. These types of accounts do not typically utilize margining and would not be eligible for this type of margining based on current agreements. Therefore, existing agreements with retail and advisory clients would also need to be updated to address the new margin requirement. This updating would be time consuming and costly. It is important to note that retail and advisory accounts do not have Master Securities Forward Transaction Agreements (MSFTAs)<sup>3</sup> in place. As the impact on counterparty and systemic risk would be low for retail and advisory accounts, but the costs to implementing the MBS Margin Proposal for those accounts would be high, FIF recommends exempting retail and advisory accounts from the MBS Margining Proposal.

Furthermore, FIF disagrees with the view noted in Regulatory Notice 14-02 that "FINRA believes that there are few retail customers that participate directly in this market". While retail and advisory accounts may represent a small percentage of MBS activity (in terms of dollar amounts), we believe there are a substantial number of retail and advisory customers that participate in the market in order to diversify their portfolios. These customers often make small purchases that would not come close to triggering the de minimum transfer amount of \$250,000, though a requirement to impose margin on those accounts would require the creation of systems to monitor those accounts and transfer margin, and the creation of separate accounts and documentation, each of which would be costly, in order for FINRA members to continue retail participation in this market. The cost of creating the new systems and accounts may force some FINRA members to exit the market and not be able to provide their clients access to this market to help diversify their portfolios.

## **Match TMPG Recommendations**

It important to note that while FINRA was "informed by the set of best practices adopted by the" TMPG recommendations, what is being proposed has some significant differences from the TMPG recommendations. For example, the MBS Margining Proposal creates a distinction between exempt and non-exempt accounts and requires maintenance margin to be collected for all non-exempt accounts. The creation of accounts that are required to have maintenance margin and those exempt from maintenance margining will introduce operational costs in setting up a system to determine which accounts qualify for exemption and having to monitor those types of accounts and will require the re-negotiation of all existing MSFTAs that do not require mandatory maintenance margin. The inclusion of mandatory maintenance margin is a significant departure from TMPG recommendations. FIF recommends that FINRA not mandate that maintenance margin be collected on MBS trades and therefore eliminate the need for exempt and non-exempt accounts as described in the proposal.

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<sup>2</sup> For purposes of the exemption, FIF believes that retail accounts would be defined as those accounts that do not meet the Rule 4512(c) definition of "institutional account."

<sup>3</sup> Master Securities Forward Transaction Agreements (MSFTAs) provide a legal framework for agency MBS forward trading and the margining of such transactions and are recognized as the industry standard agreement by the Treasury Market Practices Group. See November 14, 2012 TMPG Press Release, TMPG Recommends Margining of Agency MBS Transactions to Reduce Counterparty and Systemic Risks

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Another example of divergence from TMPG recommendations is the requirement to margin at the sub-account level. When investment adviser accounts use third party asset managers, broker-dealers may not have a relationship with the sub-account parties. Margining at the sub-account level diverges from current practice and would impose additional operational burden given the multiple sub-accounts typically associated with an adviser. If FINRA matched TMPG recommendations to margin at the adviser account level this would not be an issue.

The consequence of these differences from the TMPG recommendations is the imposition of significant operational and legal costs while not significantly improving counterparty and systemic risks. In order to avoid these costs with only a small benefit, FIF recommends that the FINRA proposal match TMPG recommendations.

## **Account for Current Business Practices**

Several aspects of the MBS Margining proposal are already addressed in the form MSFTA, which was revised to contemplate the TMPG recommendations and are the market standard agreements for this market. Rather than creating new requirements in the MBS Margining proposal, FIF recommends leveraging MSFTA concepts as follows:

- Eligible collateral is generally specified in the MSFTA and negotiated by the parties. As FINRA states the current market convention is to use cash and Treasuries. Rather than deviating from current market practice, FIF recommends that FINRA match their rule to industry practice and define collateral to include the posting of cash and U.S. Treasuries. This approach simplifies marking collateral to market and reduces the need for maintenance of haircut schedules and additional counterparty negotiations.
- Risk limits are currently defined at the adviser/manager level. As stated earlier, it should not be a requirement to set risk limits at the sub-account level. Rather than defining risk limits in the MBS Margining Proposal, firms should be permitted to set limits in MSFTAs based on an analysis of counterparty risk.
- Close out requirements are generally specified in the MSFTA form based on the facts and circumstances of the bilateral agreement. Rather than defining risk limits in the MBS Margining Proposal, FIF recommends that close-out requirements continue to be part of MSFTAs based on broker dealer and counterparty determinations.
- The identification of a “de minimis transfer amount” below which the member need not collect margin is already a negotiated term of the MSFTA. Rather than defining a de minimis transfer amount in the MBS Margining Proposal, FIF recommends that the de minimis transfer amount be set on a counterparty-by-counterparty basis since the appropriate amount will differ based on the facts and circumstances of the counterparty relationship. Additionally, FIF recommends extending the concept of de minimis transfer amount such that there be no capital charge when collateral is not collected below the de minimis transfer amount. We believe this would be consistent with the intent of permitting a de minimis transfer amount.

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Finally, there is no discussion in TMPG recommendations or the FINRA proposal on what happens if a transaction fails. We would expect broker-dealers would continue margining until an item clears since the exposure remains until the transaction settles. The interaction between fails and collateral management should be addressed by this proposal.

## **Phase Implementation to Initially Focus On Dealer Activity**

FIF recommends phasing the implementation of the MBS Margining Proposal to initially focus on dealer activity. While additional work will be required, dealers are better positioned to address margining requirements either as part of their existing Mortgage-Backed Securities Division (MBSD) relationships or through bi-lateral agreements for those securities not covered by MBSD.<sup>4</sup> This approach would give the industry sufficient time to work with MBSD to incorporate institutions into MBSD margining services and address other issues unique to institutional clients. It is our understanding that MBSD would consider additional membership structures including non-guaranteed services for institutions that would like to participate in the margining services of MBSD without becoming full members. Additional time is required for further analysis and development of these concepts including the possibility of institutions to join at the fund manager level rather than at the sub-account level as well as the expansion of coverage to include ARMs and CMOs.

Allowing MBSD to perform the required margining services has a number of operational benefits including allowing the industry to reduce costs by leveraging an existing utility service and benefiting from a common mark-to-market transaction price. If MBSD does not act as the independent third party for pricing, other alternatives would need to be evaluated. It will be critical to have independent third party pricing in order to achieve agreement on the value of a transaction subject to margining.

We understand that FINRA has recently renewed its efforts to consider the costs and benefits of its proposals and we urge FINRA to consider the significant costs associated with developing stand-alone margin functionality including:

- Buy/build operational tools to perform margining/collateral management functionality. Implementation effort would include analysis, development and testing.
- Review of outside custodians to hold collateral
- External counsel review of agreements, standards, etc. (legal fees)
- Increased transactional cost for all the back and forth movement of money
- Possible increased headcount to manage and maintain new processes

Additionally, the impact to the MBS marketplace as a whole should be considered. FIF members believe there is a possibility that this proposal will drive participants out of the market – both existing dealers and clients. The impact would be less liquidity and increased spreads. Also, the current requirement to margin at the sub-account level will adversely impact smaller asset managers if they are buying big blocks and selling them to smaller sub-accounts. These asset managers could find themselves hit by margin calls on the buy-side of the transaction without the ability to issue calls on the other side of the transaction. The net result could be either increased processing costs for investors or participants being forced out of the market.

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<sup>4</sup> MBSD is a division of DTCC and currently acts as the only central clearing counterparty for mortgage backed securities. It is important to note that MBSD does not provide margining services for ARMs or CMOs.

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Another area of complexity that requires addressing is the common practice of allowing institutional clients a grace period for collection of call. Further discussion is required to link institutional client grace periods to timing of collection of calls that trigger net capital charges for broker dealers. Grace periods are often viewed as essential to clients outside the U.S. who need sufficient time during their business day to fulfill margin obligations. By focusing initially on dealer activity, the implications of grace periods on collection of call can be addressed.

FIF recommends an implementation period of twelve to eighteen months after which dealer activity be subject to an amended MBS margining proposal. There may be significant operational builds that are required to comply with the rule and many firms may already have their technology budgets for 2014 locked into place. Furthermore, the timeframe for inclusion of institutional activity should take into account a realistic assessment of when MBSD will have expanded access to margining services for participants in the MBS space.

FIF would welcome the opportunity to discuss our recommendations with FINRA. Please do not hesitate to contact me at 312-953-9228 or [kimmel@fif.com](mailto:kimmel@fif.com).

Regards,

A handwritten signature in black ink that reads "Manisha Kimmel". The signature is written in a cursive, flowing style.

Manisha Kimmel  
Executive Director  
Financial Information Forum