INVESTMENT COMPANY INSTITUTE

MEMO# 29386

September 30, 2015

FINRA Submits Revised Proposal on Margin Requirements for To Be Announced Transactions

[29386]

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TO: DERIVATIVES MARKETS ADVISORY COMMITTEE No. 70-15
FIXED-INCOME ADVISORY COMMITTEE No. 30-15
INVESTMENT ADVISER MEMBERS No. 23-15 RE: FINRA SUBMITS REVISED PROPOSAL ON MARGIN REQUIREMENTS FOR TO BE ANNOUNCED TRANSACTIONS

On September 24, the Financial Industry Regulatory Authority ("FINRA") submitted to the Securities and Exchange Commission ("SEC" or "Commission") a revised proposed rule change ("Proposal") to amend FINRA Rule 4210. [1] The Proposal would establish margin requirements for To Be Announced ("TBA") transactions. [2] The Proposal follows a 2014 proposal by FINRA to amend Rule 4210 ("2014 Proposal"), [3] and reflects comments received by FINRA on that proposal, although the Proposal is largely unchanged from the 2014 Proposal. Comments on the Proposal are due 21 days after the SEC's notice of the Proposal is published in the Federal Register. Relevant aspects of the Proposal are summarized briefly below.

Scope of Proposal

The Proposal would apply to FINRA members engaging in "Covered Agency Transactions" with counterparties specified under the Proposal. Covered Agency Transactions would be defined to include, similar to the 2014 Proposal, [4] TBA transactions and Specified Pool Transactions, both as defined under FINRA rules, [5] for which the difference between the trade date and contractual settlement date is greater than one business day, as well as certain Collateralized Mortgage Obligations ("CMOs"), defined under FINRA rules, [6] for which the difference between the trade date and contractual settlement date is greater than three business days. Although ICI and other commenters requested that the definition be narrowed to include only transactions for which the difference between trade date and contractual settlement date is greater than three business days, FINRA declined to make this change. FINRA explained that the staff of the FRBNY 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." [7] FINRA stated that it instead has addressed these concerns by revising certain of the exceptions to the margin requirements, described below.

Proposed Margin Requirements

The Proposal would impose on FINRA members engaging in Covered Agency Transactions the requirement to collect margin as follows:

- Variation margin, [8] with respect to exempt accounts.
- Both maintenance margin [9] and variation margin, with respect to non-exempt accounts. [10]

An "exempt account" includes a number of institutional accounts, including registered investment companies. [11] If a 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 it arises, the FINRA member must take a capital charge until the loss or deficiency [12] is satisfied. If it is not satisfied within five business days from the date the loss or deficiency was created, however, the member must close out the position, unless FINRA has specifically granted the member additional time. [13] All of these proposed requirements are similar to those in the 2014 Proposal.

Despite comments of ICI and others, FINRA declined to impose bilateral margin requirements or require that margin be held through tri-party custodial arrangements for certain counterparties (such as funds). FINRA explained that, although it "is supportive of enhanced customer protection wherever possible, implementation of such requirements at this time could impose substantial burdens on members, or otherwise raise issues that are beyond the scope of the proposed rule change." [14] FINRA noted, however that it "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." FINRA stated further that it "is considering the issue of tri-party arrangements but does not propose to address it as part of the proposed rule change."

Exceptions to Margin Requirements

The Proposal includes several exceptions to the proposed margin requirements. First, as in the 2014 Proposal, the margin requirements would not apply to Covered Agency Transactions that are cleared through a registered clearing agency and are subject to the margin requirements of the clearing agency.

Second, the Proposal includes a new exception from the margin requirements intended to address concerns regarding the scope of the definition of "Covered Agency Transactions." Under the proposed exception, no margin requirements would apply to any counterparty that has gross open positions in Covered Agency Transactions with a FINRA member amounting to $2.5 million or less in the aggregate subject to certain conditions. [15]

Third, the Proposal includes an exception, similar but not identical to that included in the 2014 Proposal, for de minimis $250,000 transfer amounts. FINRA declined to increase the minimum $250,000 transfer amount, as requested by ICI and other commenters, explaining that is believes it is "necessary to set a parameter for limiting excessive risk." [16] It did, however, address commenters' concerns regarding capital charges by revising the language in the Proposal to state that a FINRA member need not take a charge to net capital if the aggregate amounts of margin to be collected from a counterparty does not exceed $250,000.

Risk Limit Determinations

The Proposal, like the 2014 Proposal, would require that FINRA members that engage in Covered Agency Transactions with any counterparty make a written determination of a risk limit to be applied to each 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.

In connection with the 2014 Proposal, FINRA had proposed to establish Supplementary Material .05 to Rule 4210, which would address certain issues regarding the risk limit determination. In response to comments that FINRA members should be permitted to define risk limits at the investment adviser or manager level rather than the sub-account level, FINRA proposes to further revise Supplementary Material .05 to provide that if a FINRA member engages in transactions with advisory clients of a registered investment adviser, the member could 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 could 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.

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endnotes

[1] Available at http://www.finra.org/sites/default/files/rule_filing_file/SR-FINRA-2015-036.pdf.

[2] FINRA Rule 6710(u) defines "TBA" to mean, among other things, a transaction in an Agency Pass-Through Mortgage-Backed Security or a Small Business Administration-Backed Asset-Backed Security 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.

[3] Margin Requirements, Regulatory Notice 14-02 (January 2014), available at http://www.finra.org/sites/default/files/NoticeDocument/p439087.pdf . FINRA had issued the 2014 Proposal after the Treasury Market Practices Group ("TMPG"), which is sponsored by the Federal Reserve Bank of New York ("FRBNY"), issued best practices for securities including TBA transactions in May 2013. Those best practices, which have since been further revised, recommend that parties exchange two-way variation margin on a regular basis. See TMPG, Best Practices for Treasury, Agency Debt, and Agency Mortgage-Backed Markets (revised June 2015), available at http://www.newyorkfed.org/tmpg/TMPG_June%202015_Best%20Practices.pdf ("TMPG Best Practices").

[4] The 2014 Proposal instead used the term "Covered Agency Securities."

[5] See FINRA Rules 6710(u) and (x).

[6] See FINRA Rules 6710(dd), (k), and (n).

[7] Proposal, supra note 1, at 52. The TMPG has issued recommendations for margining based on the type of agency MBS transaction and the existing market trading and settlement conventions for each transaction type. The TMPG recommends that, for TBA and specified pool transactions, trades for which the difference between trade date and contractual settlement date is greater than one business day should be subject to margining, and for CMO transactions, trades for which the difference between trade date and contractual settlement date is greater than three business days should be subject to margining. TMPG, 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 .

[8] Variation margin is called "mark to market loss" under the Proposal and defined as "the counterparty's loss resulting from marking a Covered Agency Transaction to the market."

[9] Maintenance margin would be defined as "margin equal to 2 percent of the contract value of the net 'long' or net 'short' position, by CUSIP, with the counterparty."

[10] A "non-exempt account" is any account that is not an "exempt account."

[11] FINRA Rule 4210(a)(13).

[12] A "deficiency" would be defined as the "amount of any required but uncollected maintenance margin and any required but uncollected mark to market loss."

[13] Proposed Supplementary Material .03 would state explicitly, however, that 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.

[14] Proposal, supra note 1, at 69-70.

[15] To rely on the exception, the original contractual settlement for all such transactions must be in the month of the trade date for such transactions or be in the month succeeding the trade date for such transactions, and the counterparty must regularly settle its Covered Agency Transactions on a Delivery Versus Payment ("DVP") Basis or for cash. The exception is not available to a counterparty 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.

[16] Proposal, supra note 1, at 130.
