

MEMO# 35397

August 14, 2023

SEC Approves Amendment to the Margin Requirements Under FINRA Rule 4210 for Transactions in the TBA Markets

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TO: ICI Members

Derivatives Markets Advisory Committee

Fixed-Income Advisory Committee

Investment Advisers Committee

Securities Operations Advisory Committee SUBJECTS: Compliance

Derivatives

Fixed Income Securities RE: SEC Approves Amendment to the Margin Requirements Under FINRA Rule 4210 for Transactions in the TBA Markets

On July 27, 2023, the SEC issued an order (the "2023 Order") approving FINRA's proposed amendments to FINRA Rule 4210 related to margin requirements for "Covered Agency Transactions" (defined below) in the to-be-announced (TBA) market.[\[1\]](#) The amendments: (1) eliminate the two percent maintenance margin requirement that applies to non-exempt accounts under current FINRA Rule 4210; (2) permit broker-dealers to take a capital charge in lieu of collecting the mark to market loss, subject to specified conditions and limitations; and (3) make revisions designed to streamline, consolidate, and clarify the text of FINRA Rule 4210. The prior margin collection requirements under FINRA Rule 4210 for Covered Agency Transactions were scheduled to become effective on October 25, 2023.[\[2\]](#) The 2023 Order amended that effective date to be between nine and ten months after the issuance of the 2023 Order and allotted FINRA 60 days to determine and announce such effective date. As of the date of this memo, FINRA has not yet announced an effective date.

The 2023 Order is the culmination of an almost decade long process regarding the margin requirements for Covered Agency Transactions. This memorandum summarizes the procedural process leading up to the issuance of the 2023 Order as well as the substantive amendments contained in the 2023 Order.

Initial Adoption in 2016 of Covered Agency Transaction Margin Requirements

In 2016, FINRA adopted amendments to Rule 4210 establishing margin and risk

requirements for transactions in the TBA markets (the "2016 Order"), specifically: (1) TBA transactions,^[3] inclusive of adjustable-rate mortgage (ARM) transactions; (2) Specified Pool Transactions;^[4] 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 (collectively, "Covered Agency Transactions").^[5] Broadly, the 2016 Order required FINRA's broker-dealer members to: (1) perform credit risk determinations for counterparties with whom the broker-dealer engages in Covered Agency Transactions; and (2) collect margin from counterparties with respect to their Covered Agency Transactions with the broker-dealer. Regarding margin collection, FINRA broker-dealer members (unless an exception applied) must collect the daily mark to market loss (i.e. variation margin) from all counterparties with respect to their Covered Agency Transactions and, for non-exempt accounts only, also collect maintenance margin of two percent. Accounts of registered investment companies and certain other institutional investors constitute "exempt accounts" not subject to maintenance margin.^[6] Further, margin obligations would need to exceed \$250,000 with a single counterparty before such counterparty would need to start posting margin. While the credit risk determination requirements went into effect on December 15, 2016, the effective date for the margin collection requirements were repeatedly delayed.^[7]

Issuance of the 2023 Order and Adoption of the Amendments to the Margin Collection Requirements for Covered Agency Transactions

A. Procedural History

Part of the reason the margin collection requirements were continually delayed was their potential adverse impact on smaller broker-dealers. In the 2016 Order, FINRA stated that it may be necessary to amend the margin collection requirements to mitigate their impact on smaller broker-dealers.^[8] In May 2021, FINRA filed a proposed rule change to address these concerns.^[9]

After the SEC published the proposal for notice and comment and FINRA filed an amended filing in response to comments received, the SEC's Division of Trading and Markets, pursuant to delegated authority, approved FINRA's proposed amendments.^[10] In response to that order, the Bond Dealers of America and Brean Capital, LLC jointly filed a petition (the "Petition") requesting that the SEC review the Division's approval of the proposed amendments.^[11] The SEC granted the Petition. Based on its review of the Petition, the SEC concluded that FINRA had met its burden to show that the proposed amendments are consistent with the requirements of the Exchange Act and issued the 2023 Order approving FINRA's proposed amendments.^[12]

B. 2023 Order and Adopted Amendments

The amendments to FINRA's Covered Agency Transaction margin collection requirements approved by the SEC as part of the 2023 Order (1) eliminate the two percent maintenance margin requirement that applies to non-exempt accounts under current FINRA Rule 4210; (2) permit broker-dealers to take a capital charge in lieu of collecting the mark to market loss, subject to specified conditions and limitations; and (3) make revisions designed to streamline, consolidate, and clarify the text of FINRA Rule 4210. Each of the main amendments that were part of the 2023 Order are discussed below.

1. Elimination of Two-Percent Maintenance Margin Requirement for Non-Exempt Accounts

Due to the elimination of the two-percent maintenance margin requirement for non-exempt accounts, now both exempt and non-exempt accounts are subject to the same margin treatment. FINRA members must collect variation margin or otherwise comply with the capital charge option.

2. Option for Taking Capital Charge in Lieu of Collecting Mark to Market Margin

The 2023 Order provides FINRA members with the option to take a capital charge in lieu of collecting margin for excess net mark to market losses. Informed by FINRA's engagement with members, this amendment was FINRA's attempt to alleviate the competitive disadvantage of smaller firms vis-à-vis larger firms or other entities not subject to FINRA's margining requirements. To avail itself of this option, however, a FINRA member must:

- Deduct the amount of the counterparty's unmargined excess net mark to market loss from its net capital if the counterparty is a non-margin counterparty^[13] or if the excess loss has not been margined or eliminated by the close of the next business day after the business day on which such excess net mark to market loss arises;
- Establish and enforce risk management procedures reasonably designed to ensure that the member will not exceed prescribed concentration thresholds^[14] and will not allow its combined net capital charges related to Covered Agency Transactions to exceed \$25 million across all accounts;
- Inform FINRA if net capital charges for Covered Agency Transaction from all accounts combined exceed \$25 million for five consecutive business days. If such charges exceed the lesser of \$30 million or 25% of the member's tentative net capital for five consecutive business days, then the member cannot enter into any new Covered Agency Transactions with any non-margin counterparty other than risk-reducing transactions. The member must also promptly, to the extent of its rights, collect margin for each counterparty's excess net mark to market loss and promptly liquidate the Covered Agency Transactions of any counterparty whose excess net mark to market loss is not margined or eliminated within five business days from the date it arises, unless FINRA has specifically granted the member additional time; and
- Submit to FINRA information regarding its unmargined net mark to market losses, non-margin counterparties and related capital charges, in the form and manner prescribed by FINRA.

3. Conforming Technical Changes

The amended rule also makes several technical changes, including:

- Clarifying that margin or a capital charge need not be collected or charged, respectively, with activity below the \$250,000 minimum transfer amount and margining or capital charges only need to be taken in the amount exceeding the \$250,000 minimum transfer amount;
- Clarifying that a FINRA member may treat a counterparty under the "small cash counterparty" exception to the margin collection requirements if such counterparty has \$10 million or less in gross open Covered Agency Transaction positions with the FINRA member, among other criteria;

- Modifying the definition of "counterparty" to clarify the excepted counterparties from the margin collection requirements for Covered Agency Transactions as well as clarifying that "counterparty" does include circumstances in which a FINRA member guarantees a transaction of such counterparty;
- Modifying the definition of "non-margin counterparty" to exclude small cash counterparties and other exempted counterparties;
- Defining a FINRA member's "specified net capital deductions" as the net capital deductions required by the capital charge subsection (paragraph (e)(2)(H)(ii)d.1. of FINRA Rule 4210) with respect to all unmargined excess net mark to market losses of its counterparties, except to the extent that the member, in good faith, expects such excess net mark to market losses to be margined by the close of business on the fifth business day after they arose.

4. Effective Date

FINRA will announce, within 60 days after the issuance of the 2023 Order, an effective date of between nine to ten months after the issuance of the Order. Unless further delayed by FINRA or stayed due to a challenge in federal appellate court, FINRA members will be required to comply on that date with the amended margin collection requirements for Covered Agency Transactions, as adopted pursuant to the 2023 Order.

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Assistant General Counsel

Notes

[1] Order Setting Aside Action by Delegated Authority and Granting Approval of a Proposed Rule Change, as Modified by Amendment No. 1, to Amend the Requirements for Covered Agency Transactions under FINRA Rule 4210 (Margin Requirements) as Approved Pursuant to SR-FINRA-2015-036, Exchange Act Release No. 98003 (July 27, 2023), available at <https://www.sec.gov/files/rules/sro/finra/2023/34-98003.pdf>. The adopted text of amended FINRA Rule 4210 can be found at SR-FINRA-2021-010 Amendment No. 1, at 21-33 (Aug. 9, 2021), available at https://www.finra.org/sites/default/files/2021-08/SR-FINRA-2021-010-Amendment_1.pdf.

[2] Notice of Filing and Immediate Effectiveness of a Proposed Rule Change to Extend the Implementation Date of Certain Amendments to FINRA Rule 4210 Approved Pursuant to SR-FINRA-2015-036, Exchange Act Release No. 97062 (March 7, 2023), available at <https://www.sec.gov/files/rules/sro/finra/2023/34-97062.pdf> ("2023 Extending Release").

[3] FINRA Rule 6710(u) defines TBA to mean a transaction in an agency pass-through mortgage-backed security 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 mortgages 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.

[4] FINRA Rule 6710(x) defines "Specified Pool Transaction" to mean a transaction in an

agency pass-through mortgage-backed security or an SBA-Backed ABS requiring the delivery at settlement of a pool or pools that is identified by a unique pool identification number at the time of execution.

[5] Notice of Filing of Amendment No. 3 and Order Granting Accelerated Approval to a Proposed Rule Change to Amend FINRA Rule 4210 (Margin Requirements) to Establish Margin Requirements for the TBA Market, as Modified by Amendment Nos. 1, 2, and 3, Exchange Act Release No. 78081 (June 15, 2016), available at <https://www.sec.gov/files/rules/sro/finra/2016/34-78081.pdf>.

ICI commented on both FINRA's proposed amendments and on its filing of a proposed rule change with the SEC. See FINRA Requests Comment on Proposed Amendments to FINRA Rule 4210 for Transactions in the TBA Market, FINRA Regulatory Notice 14-02 (Jan. 27, 2014), available at <https://www.finra.org/rules-guidance/notices/14-02> and Letter from Karrie McMillan, General Counsel, ICI to Marcia E. Asquith, Office of the Corporate Secretary, FINRA on Margin Requirements (March 27, 2014), available at <https://www.finra.org/sites/default/files/NoticeComment/p473385.pdf>; also Notice of Filing of a Proposed Rule Change to Amend FINRA Rule 4210 (Margin Requirements) to Establish Margin Requirements for the TBA Market, Exchange Act Release No. 76148 (Oct. 14, 2015), available at <https://www.sec.gov/files/rules/sro/finra/2015/34-76148.pdf> and Letter from David W. Blass, General Counsel, ICI to Robert W. Errett, Deputy Secretary, SEC on Notice of Filing of a Proposed Rule Change to Amend FINRA Rule 4210 (Margin Requirements) to Establish Margin Requirements for the TBA Market; File No. SR-FINRA2015-036 (Nov. 9, 2015), available at <https://www.sec.gov/comments/sr-finra-2015-036/finra2015036-12.pdf>. The 2016 Order did not include any of ICI's recommended changes.

[6] Specifically, an "exempt account" is defined as an account of a FINRA member, non-FINRA member registered broker-dealer, account that is a "designated account" under FINRA rules (specifically, a bank as defined under the Securities Exchange Act of 1934 (the "Exchange Act") § 3(a)(6), a savings association as defined under the Federal Deposit Insurance Act § 3(b), the deposits of which are insured by the Federal Deposit Insurance Corporation, an insurance company as defined under the Investment Company Act of 1940 (the "1940 Act") § 2(a)(17), an investment company registered with the SEC under the 1940 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 and meets specified conditions.

[7] The most recent delay moved the effective date to October 25, 2023. See 2023 Extending Release, *supra* note 2.

[8] See 2016 Order, *supra* note 5.

[9] Notice of Filing of a Proposed Rule Change to Amend the Requirements for Covered Agency Transactions under FINRA Rule 4210 (Margin Requirements) as Approved Pursuant to SR-FINRA-2015-036, Exchange Act Release No. 91937 (May 19, 2021), available at <https://www.sec.gov/files/rules/sro/finra/2021/34-91937.pdf>.

[10] Order Granting Approval of a Proposed Rule Change, as Modified by Amendment No. 1, to Amend the Requirements for Covered Agency Transactions under FINRA Rule 4210 (Margin Requirements) as Approved Pursuant to SR-FINRA-2015-036, Exchange Act Release No. 94013 (Jan. 20, 2022), available at

<https://www.sec.gov/files/rules/sro/finra/2022/34-94013.pdf>.

[11] See Petition for Review of the January 20, 2022, Order in File No. SR-FINRA-2021-010 issued by the Division of Trading and Markets pursuant to delegated authority Granting Approval of a Proposed Rule Change, as Modified by Amendment No. 1, to Amend the Requirements for Covered Agency Transactions under FINRA Rule 4210 as Approved Pursuant to SR-FINRA2015-036 (Feb. 3, 2022), available at <https://bit.ly/3NOCPS8>.

[12] See 2023 Order, *supra* note 1. The Petition made many arguments as to why requiring margin for Covered Agency Transactions was unnecessary. In response, FINRA argued that the 2016 Order was not at issue as part of the current proposed amendments and that FINRA was not required to re-do the entire rulemaking process related to the 2016 Order and adoption of margin requirements for Covered Agency Transactions. The SEC agreed, stating in the 2023 Order that "the only amendments to the current rule before the Commission under the proposed rule change . . . are to eliminate the two percent maintenance margin requirement, permit capital in lieu of margin charges, and to reorganize and streamline the rule text[, which] build upon the already existing exceptions adopted in the 2016 [Order.]"

[13] Paragraph (e)(2)(H)(i)e. of FINRA Rule 4210 defines a counterparty as a "non-margin counterparty" if the member: (1) does not have a right under a written agreement or otherwise to collect margin for such counterparty's excess net mark to market loss and to liquidate such counterparty's Covered Agency Transactions if any such excess net mark to market loss is not margined or eliminated within five business days from the date it arises; or (2) does not regularly collect margin for such counterparty's excess net mark to market loss. Small cash counterparties and other exempt counterparties from the Covered Agency Transaction margin collections requirements of FINRA Rule 4210 do not constitute "non-margin counterparties."

[14] FINRA Rule 4210(e)(2)(I) requires a member to provide written notification to FINRA and prohibits the member from entering into any new transactions that could increase credit exposure if net capital deductions over a five-day business period exceed: (i) for a single account or group of commonly controlled accounts, 5% of the member's tentative net capital; or (ii) for all accounts combined, 25% of the member's tentative net capital. FINRA Rule 4210(e)(2)(I) includes net capital deductions for other securities in addition to Covered Agency Transactions, as well as any unmargined net mark to market losses below \$250,000 or of small cash counterparties.