COMMENT LETTER

November 9, 2015

ICI Submits Comment Letter on FINRA Proposal to Require Margin for TBA Transactions (pdf)

November 9, 2015 Mr. Robert W. Errett Deputy Secretary Securities and Exchange Commission 100 F Street, N.E. Washington, D.C. 20549 Re: 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-FINRA- 2015-036 Dear Mr. Errett: The Investment Company Institute1 appreciates the opportunity to respond to the request for comment by the Securities and Exchange Commission ("SEC" or "Commission") on the proposal by the Financial Industry Regulatory Authority ("FINRA") on the proposed amendments to FINRA Rule 4210 for transactions in the To Be Announced ("TBA") market.2 The TBA Margin Proposal would require FINRA members carrying forward transactions with customers in "Covered Agency Transactions"3 to collect, subject to a minimum $250,000 minimum transfer amount: (i) variation 1 The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of $17.1 trillion and serve over 90 million shareholders. 2 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, 80 FR 63603 (Oct. 20, 2015), available at http://www.gpo.gov/fdsys/pkg/FR-2015-10-20/pdf/2015-26518.pdf ("TBA Margin Proposal"). 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 are not specified at the time of execution. 3 Covered Agency Transactions would be defined to include: (i) TBA transactions and Specified Pool Transactions, both as defined under FINRA rules, for which the difference between the trade date and contractual settlement date is greater than one business day; and (ii) certain Collateralized Mortgage Obligations ("CMOs"), defined under FINRA rules, for which the difference between the trade date and contractual settlement date is greater than three business days. Mr. Robert W. Errett November 9, 2015 Page 2 of 12 margin4 from exempt accounts; and (ii) both maintenance margin5 and variation margin from non- exempt accounts.6 The definition of "exempt account" includes accounts of registered investment companies and certain other institutional investors.7 The TBA Margin Proposal would establish a one- day time frame for posting of variation margin and a close-out requirement after five business days unless a customer posts variation margin. These and other proposed requirements of the TBA Margin Proposal are substantially similar to those included in FINRA's 2014 notice to members proposing amendments to Rule 4210 ("2014 FINRA Proposal").8 Although we appreciate that FINRA made several changes to the 2014 FINRA Proposal in response to comments of ICI and others,9 the TBA Margin Proposal is largely unchanged from the 2014 FINRA Proposal. We believe strongly that further changes are needed. Specifically, we recommend that FINRA: • Require Two-Way Margining. The new rule should require broker-dealers to post variation margin to customers when Covered Agency Transactions are in-the-money to the customer. • Revise the Definition of "Covered Agency Transactions." Transactions settling within three business days should not be treated as Covered Agency Transactions because they do not pose material risk beyond the ordinary settlement cycle. 4 Under the TBA Margin Proposal, variation margin is called "mark to market loss" and defined as "the counterparty's loss resulting from marking a Covered Agency Transaction to the market." 5 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." 6 A "non-exempt account" is any account that is not an "exempt account." 7 FINRA Rule 4210(a)(13). We recommend that FINRA revise the definition of "exempt account" to include similar entities, such as non-U.S. equivalents of the types of entities included under the definition of "exempt account" in Rule 4210 (e.g., UCITs), as well as collective trust funds and separately managed accounts that are not pension plans. 8 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 FINRA Proposal after the Treasury Market Practices Group ("TMPG"), which is sponsored by the Federal Reserve Bank of New York ("FRBNY"), issued best practices in May 2013 for certain securities, including TBA transactions. See TMPG, Best Practices for Treasury, Agency Debt, and Agency Mortgage-Backed Markets (revised June 2015), available at http://www.newyorkfed.org/tmpg/TPMG_June%202015_Best%20Practices.pdf ("TMPG Best Practices"). 9 See Letter from Dorothy M. Donohue, Acting General Counsel, Investment Company Institute, to Marcia E. Asquith, Office of the Corporate Secretary, FINRA, dated March 27, 2014, available at https://www.ici.org/pdf/27997.pdf. • Eliminate the Close-Out Obligation. FINRA members should be permitted to take a capital charge in lieu of collecting variation margin from an exempt account for a Covered Agency Transaction. • Increase the Minimum Transfer Amount. FINRA should raise the minimum transfer amount to $500,000 to make it consistent with international standards. • Provide an Appropriate Transition Period. We request that customers and FINRA members be given 18 months to comply with the TBA Margin Proposal, once adopted. We discuss these recommendations below. Background According to the TBA Margin Proposal, most trading of agency mortgage-backed securities ("MBS") takes place in the TBA market, which is characterized by transactions with forward settlements. The agency MBS market is one of the largest fixed income markets, and investment companies registered under the Investment Company Act of 1940 ("ICA") ("registered funds") are significant investors in that market. Registered funds own a substantial amount of MBS with taxable bond funds holding the vast majority of those assets.10 One reason registered funds invest in the TBA market is to obtain the desired mortgage exposures without having to own the underlying MBS directly. As noted by FINRA, the exchange of margin in the TBA market has not been common practice. As a practical matter, broker-dealers have neither collected any variation margin or "mark-to- market loss" with respect to exempt accounts, nor taken any capital charge in lieu of collateral.11

FINRA issued the 2014 FINRA Proposal after the TMPG issued best practices recommendations that require margining of forward-settling agency MBS transactions by all counterparties, including "exempt accounts and broker-dealers."12 According to the 2014 FINRA Proposal, in light of the growth of the TBA market, the number of participants and the credit concerns that have been raised in recent years, FINRA was of the view that there is a need to establish margin requirements for the TBA market that

10 As of June 30, 2015, registered funds held $547 billion in MBS. ICI Data. 11 Under the current margining rules, broker-dealers are required to charge maintenance margin of 5 percent plus the mark- to-market loss to non-exempt accounts. For exempt accounts, broker-dealers are not required to charge either maintenance margin or initial margin but are required to collect the mark-to-market loss in the position or take a capital charge in lieu of collection of the mark-to-market loss. See Exhibit I to Interpretations to FINRA Rule 4210(e)(2)(F). Interpretation /03 of Rule 4210(e)(2)(F) allows members to set risk limits as an alternative to deducting capital for exempt accounts and as an alternative to collecting margin and any mark to market losses for mortgage bankers' non-exempt accounts. 12 TMPG Best Practices, supra note 8. will cover not only smaller investors (which are covered under the current rules) but also cover larger, institutional investors that comprise the major part of the market. The TBA Margin Proposal is largely unchanged from the 2014 FINRA Proposal. FINRA proposes to require its members to collect variation margin from exempt counterparties for transactions in Covered Agency Transactions and to collect variation and maintenance margin equal to two percent of the market value of the securities from non-exempt accounts. 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 would be required to take a capital charge until the loss or deficiency13 was satisfied. If it was not satisfied within five business days from the date the loss or deficiency was created, however, the member would be required to close out the position, unless FINRA specifically granted the member additional time.14 As in the 2014 FINRA Proposal, transactions cleared through a registered clearing agency and subject to margin requirements of the clearing agency would not be subject to the proposed requirements. Under a proposed exception similar but not identical to one included in the 2014 FINRA Proposal, margin for both exempt and non-exempt accounts would be subject to a de minimis threshold of $250,000, below which a FINRA member would not be required to collect margin from a counterparty or charge such amount to net capital. Under a new proposed exception, a FINRA member also would not be required to collect margin from any counterparty that has gross open positions in Covered Agency Transactions with the member amounting to $2.5 million or less in the aggregate, subject to certain conditions.15 In addition, the TBA Margin Proposal, like the 2014 FINRA 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.16 The risk limit determination would

13 A "deficiency" would be defined as the "amount of any required but uncollected maintenance margin and any required but uncollected mark to market loss." 14 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. 15 In response to comments on the 2014 FINRA Proposal, FINRA has proposed an exception to the maintenance margin requirement for non-exempt accounts if the original contractual settlement for the Covered Agency Transaction 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 on a "delivery versus payment" ("DVP")

basis or for cash. The exception is not available 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. 16 FINRA also proposes to revise Supplementary Material .05 to Rule 4210, which would address certain issues regarding the risk determination, to provide that if a FINRA member engages in transactions with advisory clients of a registered Mr. Robert W. Errett November 9, 2015 Page 5 of 12 need to be made by a credit risk officer or credit risk committee in accordance with the member’s written risk policies and procedures. Discussion FINRA Should Require Two-Way Margining Despite comments of ICI and others on the 2014 FINRA Proposal, FINRA declined to propose bilateral margin requirements under the TBA Margin Proposal. 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.”17 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.” We strongly urge FINRA to require its members to post variation margin to their counterparties at the same level and in the same manner as required for the counterparty. Two-way margining is critically important to protect counterparties of broker-dealers (which are treated by FINRA as “customers” of the member firm)18 and the TBA markets generally. Bilateral margin is essential to managing risk for Covered Agency Transactions as well as for the reduction of a build-up of systemic risk at institutions that engage in a significant number of these transactions.19 We believe that a two-way margining requirement protects counterparties (such as registered funds) and mitigates credit exposure and fail risk generally in the marketplace due to a

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. 17 TBA Margin Proposal, supra note 2, at 63620. 18 Under the proposed amendments to Rule 4210, a “counterparty” is defined as “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].” 19 In adopting the final margin rules for uncleared swaps, the prudential regulators adopted a requirement for bilateral margining because they “believe that requiring covered swap entity to post margin to other financial entities could forestall a build-up of potentially destabilizing exposures in the financial system.” See Margin and Capital Requirements for Covered Swap Entities (Oct. 22, 2015), available at https://www.fdic.gov/news/board/2015/2015-10-22_notice_dis_a_fr_final-rule.pdf (“Prudential Regulators Margin Adopting Release”). Mr. Robert W. Errett November 9, 2015 Page 6 of 12 concentration of TBA transactions at a limited number of broker-dealer firms. We are concerned that FINRA has not articulated adequately the reason for not requiring bilateral margining even though it acknowledges the benefits of two-way margining.20 The daily exchange of variation margin serves to remove current exposure from the TBA markets for all participants and to prevent exposures from accumulating. Two-way exchange of variation margin will provide protection to market participants against the market value losses that could otherwise build up at broker-dealers (i.e., the entities that engage in significant volume of TBA transactions), which could threaten systemic stability in the financial markets. We do not believe that potential burdens to FINRA members of posting margin in connection with TBA Transactions outweigh these substantial benefits. Two-way margining is an important element to accomplish FINRA's stated goals in the TBA Margin Proposal of addressing systemic risk and counterparty exposure concerns raised by unmargined TBA trading.21 We strongly disagree that two-way margining would "raise issues that are beyond the scope of the proposed rule change . . ."22 Rather, bilateral margining would directly address FINRA's concerns about systemic risk and counterparty exposure. TBA transactions involve two-sided exposures in the same way as futures, options, swaps, repurchase transactions and securities lending transactions. In connection with uncleared derivatives markets, we have consistently advocated for a two-way margining requirement globally to reduce systemic risk and promote central clearing.23 We were gratified that the international regulators

20 We question why FINRA proposes to take a different approach from the TMPG with respect to the bilateral margining for TBA transactions when FINRA has determined not to amend other aspects of the TBA Margin Proposal to seek consistency with the TMPG Best Practices. Those best practices recommend that parties exchange two-way variation margin on a regular basis. 21 TBA Margin Proposal, supra note 2, at 63604. 22 Id. at 63620. 23 See Letter from Dan Waters, Managing Director, ICI Global, to Robert deV. Frierson, Secretary, Board of Governors of the Federal Reserve System, et al., dated Nov. 24, 2014, available at https://www.ici.org/pdf/28541.pdf; Letter from Karrie McMillan, General Counsel, ICI, and Dan Waters, Managing Director, ICI Global, to Wayne Byres, Secretary General, Basel Committee on Banking Supervision, Bank for International Settlements, and David Wright, Secretary General, International Organization of Securities Commissions, dated March 14, 2013, available at http://www.ici.org/pdf/27111.pdf; Letter from Karrie McMillan, General Counsel, ICI, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, dated February 4, 2013, available at http://www.ici.org/pdf/26967.pdf; Letter from Karrie McMillan, General Counsel, ICI, and Dan Waters, Managing Director, ICI Global, to Wayne Byres, Secretary General, Basel Committee on Banking Supervision, Bank for International Settlements, and David Wright, Secretary General, International Organization of Securities Commissions, dated September 27, 2012, available at adopted a bilateral margining requirement as part of the final policy framework establishing minimum standards for margin requirements for non-centrally cleared derivatives.24 The international standards recognize that two-way margin is an essential component of managing risk for derivatives transactions as well as for reducing systemic risk in the derivatives markets. The U.S. prudential regulators likewise recently have adopted, and the CFTC has proposed, bilateral margining for uncleared derivatives transactions.25 Significantly, FINRA recognizes in the TBA Margin Proposal that "[t]he repercussions of unmargined bilateral credit exposures are demonstrated in the Bear Stearns and Lehman Brothers failures in 2008. . . ."26 We encourage FINRA to include the important protection of bilateral margining in the rule it adopts for the TBA market, and we believe failure to adopt these protections would undermine FINRA's rationale for adopting the rule.27 Some have argued that, even without a regulatory requirement, registered funds could negotiate for bilateral margining when entering into TBA transactions with their broker-dealers. We do not agree. History has shown that this kind of approach is not practical. Broker-dealers possess significant market and bargaining power. This is especially true relative to smaller registered funds. Without a requirement for broker-dealers to post margin to their counterparties, registered funds will find negotiating for bilateral margining difficult and costly.

http://www.ici.org/pdf/26529.pdf; Letter from Karrie McMillan, General Counsel, ICI, to David A. Stawick, Secretary, CFTC, dated September 13, 2012, available at http://www.ici.org/pdf/26500.pdf. 24 Basel Committee on Banking Supervision and Board of the International Organization of Securities Commissions, Margin Requirements for Non-Centrally-Cleared Derivatives, September

2013, available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD423.pdf ("BCBS/IOSCO Final Policy Framework"). 25 See Prudential Regulators Margin Adopting Release, supra note 19; Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 79 FR 59898 (Oct. 2, 2014) ("CFTC Margin Proposal"). The SEC, however, has proposed unilateral margining in its proposed rules for security-based swap dealers and major security-based swap participants although ICI and other commenters have advocated strenuously for a bilateral margining regime. See Letter from Paul Schott Stevens, President and CEO, ICI, to The Honorable Mary Jo White, Chair, SEC, dated May 11, 2014, available at http://www.ici.org/pdf/28969.pdf; Letter from Karrie McMillan, General Counsel, ICI, to Ms. Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, dated December 5, 2013, available at https://www.ici.org/pdf/27742.pdf. 26 TBA Margin Proposal, supra note 2, at 63610. 27 See Section 3(f) of the Securities Exchange Act of 1934. In our view, FINRA has the necessary authority to require these changes and to require posting of margin by member firms just as FINRA clearly has authority to require member firms to collect maintenance and variation margin from customers (i.e., in this case, "counterparties," because, as the TBA Margin Proposal explains, counterparties to Covered Agency Securities transactions are deemed to be "customers"). We respectfully request that incorporation of a broker-dealer margin posting requirement be added as a condition to approval of the TBA Margin Proposal. Mr. Robert W. Errett November 9, 2015 Page 8 of 12   FINRA Should Modify the Definition of Covered Agency Transactions In response to the 2014 FINRA Proposal, we had requested that the definition of "Covered Agency Securities" (now "Covered Agency Transactions") be modified to include only TBA transactions and Specified Pool Transactions for which the difference between trade date and contractual settlement date is greater than three business days rather than one business day as currently proposed. We explained that defining forward transactions to include transactions settling one business day after the trade date would be inconsistent with the current margining regime for regularly- settled transactions. A broker-dealer has until T+5 to collect payment in a cash account for a purchase of securities before the position must be liquidated.28 In the TBA Margin Proposal, FINRA acknowledged our comment and similar comments, but declined to revise the proposed definition of Covered Agency Transactions, explaining 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."29 Although FINRA asserted "it would undermine the effectiveness of the proposal to modify the product types to which the proposal would apply or modify the applicable settlement cycles . . ."30 it stated that it has addressed commenter concerns by adding the proposed new exception to margin requirements for gross open positions of $2.5 million or less in the aggregate, as described above. FINRA said that it believes the exception should reduce potential burdens on members "by removing from the proposal's scope smaller intermediaries that do not pose systemic risk."31 We disagree. The proposed $2.5 million exception does not address our concerns with respect to the scope of the definition of "Covered Agency Transactions." Although we recognize that the proposed exception would be helpful for smaller accounts, the exception would not alleviate burdens for exempt accounts, such as registered funds. We continue to believe that transactions that settle within the current three-day settlement cycle for cash transactions present minimal credit risk and should not be subject to margin requirements. FINRA asserts that margin should be required for these

28 This five day period is consistent with the payment cycle for fully-paid security transactions. See Section 220.8(b) of Regulation T (requiring, for purchases in a cash account, payment within one "payment period" (i.e., the three business days pursuant to SEC Rule 15c6-1(a)) plus two business days). 29 TBA Margin Proposal, supra note 2, at 63605. 30 Id. at 63616. 31 Id. Mr. Robert W. Errett

November 9, 2015 Page 9 of 12 short-dated transactions, yet it has not addressed the likely negative consequences of imposing margin on such transactions.32 A requirement to margin TBA transactions and Specified Pool Transactions for which the difference between trade date and contractual settlement date is shorter than three business days would impose a cost that is wholly disproportionate with the risk. Although margining does reduce counterparty credit risk, it can introduce operational and other risks.33 There is a potential for mistakes or errors to occur in each step of the margining process, which should be considered in evaluating when margin requirements should apply. Requiring counterparties to post margin against these instruments that settle in three days or fewer will create more systemic and operational risks than it will mitigate. If this requirement were to be adopted by FINRA, in many cases, counterparty collateral would be delivered to the broker-dealer after the transactions have settled, which would expose the counterparty to broker-dealer bankruptcy risk at a time when the broker-dealer has no exposure to the customer and would create unnecessary costs of return and potential difficulties in identifying the settlement details for the broker-dealer. FINRA Should Increase the Minimum Transfer Amount FINRA proposes to require variation margin for transactions when the current exposure exceeds $250,000. In response to comments of ICI and others on the 2014 FINRA Proposal that the de minimis transfer amount should be higher and not result in members incurring a capital charge, FINRA declined to increase the minimum $250,000 transfer amount, explaining that it believes it is “necessary to set a parameter for limiting excessive risk . . . ”34 It did, however, address commenters’ concerns regarding capital charges by revising the language in the TBA Margin Proposal to state that a

32 We are aware that 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. For the reasons discussed, however, we believe this aspect of the TMPG recommendations, like this aspect of the TBA Margin Proposal, would impose a cost that is wholly disproportionate to the risk of the transactions. 33 See Report of the TMPG, Margining in Agency MBS Trading (November 2012) at 4, available at http://www.newyorkfed.org/tmpg/margining_tmpg_11142012.pdf (noting that margining would involve functions such as “measuring forward exposures, marking open positions, calculating the margin amount, communicating margin calls to counterparties, and delivering and receiving collateral”). 34 TBA Margin Proposal, supra note 2, at 63608. Mr. Robert W. Errett November 9, 2015 Page 10 of 12 FINRA member need not take a charge to net capital if the aggregate amounts of margin to be collected from a counterparty do not exceed the de minimis transfer amount. We appreciate FINRA addressing the capital charge issue explicitly. We believe confirmation that no capital charge will be imposed under these circumstances is necessary for the usefulness of the exception. We continue to urge FINRA, however, to increase the minimum transfer amount to $500,000, below which the counterparties would not have to exchange margin, as we believe the current proposed amount is too low. We do not believe FINRA would achieve its regulatory objectives with the proposed de minimis amount. First, although we support FINRA’s intention to propose a minimum transfer amount that is set sufficiently low to limit excessive risk and ensure that current exposure does not build up before variation margin is exchanged between

counterparties, we do not believe amounts below $500,000 would create excessive risk or result in significant build-up of current exposure. Moreover, a minimum transfer amount that is set too low would result in more frequent transfers of collateral and increase the potential for operational risk as described above. Frequent transfers of collateral also would increase transaction costs. Second, the proposed minimum transfer amount would not be consistent with standards in the derivatives markets. Under the internationally agreed upon margin policy framework for uncleared derivatives, global regulators agreed to a €500,000 minimum transfer amount.35 The prudential regulators have adopted, and the CFTC has proposed, a minimum transfer amount that is consistent with the international standards.36 We strongly encourage FINRA similarly to adopt a minimum transfer amount that would be consistent with international standards. FINRA Should Eliminate the Close-Out Obligation FINRA proposes that if variation margin is not posted by a counterparty to secure the mark-to- market loss in respect of the counterparty's position within five business days from the date the loss was created, the member would be required to take promptly liquidating action unless FINRA grants the member an extension. Under the TBA Margin Proposal, liquidation would appear to be required even if the broker-dealer member were to take a capital charge. 35 The BCBS/IOSCO originally proposed to subject counterparties to a minimum transfer amount not to exceed €100,000 but raised the minimum transfer amount to €500,000 when it issued its final policy framework. See BCBS/IOSCO Final Framework, supra note 24. 36 The prudential regulators recently adopted a minimum transfer amount of $500,000, and the CFTC proposed a minimum transfer amount of $650,000. See Prudential Regulators Margin Adopting Release, supra note 19; CFTC Margin Proposal, supra note 25. Mr. Robert W. Errett November 9, 2015 Page 11 of 12 In response to comments advocating a longer timeframe, FINRA stated in the TBA Margin Proposal that it "believes that the five-day period as proposed is appropriate in view of the potential counterparty risk in the TBA market."37 FINRA declined to revise the TBA Margin Proposal to extend the close-out period or recognize the efficacy of the capital charge. We believe that the five business day close out period should be extended or a capital charge should be adopted as an alternative. The proposed five business day period is substantially shorter than the fifteen business day close-out period that is currently provided for in FINRA Rule 4210.38 In addition, we are concerned that it is impracticable to rely on the provision allowing FINRA to "specifically grant the member additional time" to collect the additional margin when there is a deficiency because brokers have indicated that the process to extend the 5-day period is onerous and burdensome. Given these concerns, in practice, an extension of the five-day period will not likely be possible, thereby imposing a significant burden on market participants. We therefore recommend that FINRA retain its current interpretation that permits members to take a charge to net capital in lieu of collecting the mark-to-market loss from exempt accounts. Allowing broker-dealers to deduct the exposure from net capital would provide sufficient incentive for broker-dealers to collect variation margin from their counterparties without requiring them to close out the account within a set period of time. Reliance on capital charges to mitigate systemic risk when margin is not collected is a fundamental cornerstone of the SEC's and FINRA's financial responsibility rules for broker-dealers and security-based swap dealers.39 There is no reason to believe that a capital charge would be less effective with respect to Covered Agency Transactions than in connection with other types of transactions. Moreover, imposing a close-out obligation only on broker-dealers fails to recognize the bilateral exposure inherent in Covered Agency Transactions. Counterparties are exposed to the broker-dealer at all times yet FINRA does not propose to impose a similar punitive action for accounts for which a 37 TBA Margin Proposal, supra note 2, at 63619. 38 See, e.g., FINRA Rule 4210(f)(6) (permitting up to 15 business days for a member firm to obtain the required amount of margin or mark to market loss). 39 See Capital, Margin and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers, 77 FR 70214, 70242 (Nov. 23, 2012), available at http://www.gpo.gov/fdsys/pkg/FR-2012-11-23/pdf/2012-26164.pdf (“The proposed capital charge in lieu of margin is designed to address situations where a nonbank SBSD does not collect sufficient (or any) collateral to cover potential future exposure relating to cleared and non-cleared security-based swaps”). See also SEC Rule 15c3-1(c)(2)(xii) (When a “pattern day trader” fails to meet special maintenance margin calls, as required (i.e., within five business days from the date the margin deficiency occurs), on the sixth business day only, a member is required to deduct from net capital the amount of unmet maintenance margin calls for its pattern day traders); FINRA Rule 4210(e). Mr. Robert W. Errett November 9, 2015 Page 12 of 12 broker-dealer has failed to post variation margin. FINRA has not specified in any detail the rationale for proposing to amend its current position, and we recommend that this proposed requirement be removed in the final rule. FINRA Should Provide an 18-month Compliance Period In the TBA Margin Proposal, FINRA states that commenters on the 2014 FINRA Proposal suggested implementation periods from 6-24 months and that FINRA generally supports “the suggestion of an implementation period that permits members adequate time to prepare for the rule change and welcomes further comment on this issue.” We recommend a compliance period of 18 months to provide adequate time for market participants to prepare for the new requirements. Although market participants have in place written agreements for a significant portion of the TBA market, these agreements may have to be amended to reflect the new requirements adopted by FINRA. Tri-party custodial arrangements for registered funds also may have to be amended. There will be thousands of agreements that may have to be renegotiated and executed within the compliance period. * * * We appreciate the opportunity to respond to the SEC’s request for comment on FINRA’s proposal to establish margin requirements for the TBA market. We believe the recommendations discussed above should be incorporated into any new rule, which will make the margin requirements workable for market participants (including registered funds) and achieve FINRA’s regulatory objectives. If you have any questions on our comment letter, please feel free to contact me at (202) 218- 3563, Jennifer Choi at (202) 326-5876, or Sarah Bessin at (202) 326-5835. Sincerely, /s/ David W. Blass General Counsel cc: Stephen Luparello, Director, Division of Trading and Markets, SEC Gary Barnett, Deputy Director, Division of Trading and Markets, SEC Michael A. Macchiaroli, Associate Director, Division of Trading and Markets, SEC Tom McGowan, Associate Director, Division of Trading and Markets, SEC David W. Grim, Director, Division of Investment Management, SEC Doug Scheidt, Associate Director, Division of Investment Management, SEC
