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OFFICE OF THE SECRETARY

VIA FEDEX

Brent J. Fields
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Amendments to Financial Industry Regulatory Authority ("FINRA") Rule 4210

Mr. Secretary,

We represent Brean Capital, LLC ("Brean"), an independent investment bank and broker dealer with extensive experience trading in the MBS market. Brean is considering submitting a petition pursuant to 5 U.S.C. §553(e) and 17 C.F.R. §201.192(a), and writes to express grave concerns with amendments to FINRA Rule 4210 ("Rule") that the U.S. Securities and Exchange Commission ("Commission") issued on June 15, 2016. We would very much appreciate the opportunity to schedule a meeting to discuss our concerns, some of which we describe below.

I. Executive Summary

The Rule's anticompetitive nature perversely impacts the MBS market. In requiring the posting of collateral for trading with broker dealers, the Rule will likely divert business from small-to-medium sized broker dealers to regional banks and major broker dealers with a lower cost of capital, while saddling smaller brokers with extra costs of capital and operational costs. Consequently, trading will become concentrated among a small number of extremely large investment banks, reducing liquidity and mortgage pricing efficiency in the market. The Rule threatens to ultimately drive small-to-medium sized broker dealers out of the MBS market, resulting in increased borrowing costs for homeowners. These harms are compounded by the fact that the Rule requires a double-posting in the case of introducing brokers that are already subject to collateral requirements imposed by their clearing brokers.

We highlight as well that the Commission issued the Rule in excess of statutory authority under § 7 of the Exchange Act of 1934 ("Exchange Act"). The Rule requires U.S. broker-dealers to collect margin from most customers for the majority of TBA transactions. But Congress authorized only the Board of Governors of the Federal Reserve Bank of New York ("FRB") to regulate margin, and even the FRB may not regulate margin on the "exempted securities," which compose the vast majority of the Rule's Covered Agency Transactions.

II. Commercial Impact: Amended Rule 4210 is Anticompetitive

The Amended Rule's margin requirements are by their nature anticompetitive, in violation of Exchange Act §§ 15A(b)(6) and (b)(9), which require FINRA to promote fair trade principles while protecting investors and the public, and not impose any unnecessary burden on competition.[1] All three branches of government require objective cost-benefit analysis in federal rulemaking. Accordingly, Congress requires the Commission, when engaged in rulemaking under the Exchange Act, to consider "the protection of investors, [and] whether the action will promote efficiency, competition and capital formation." The Commission must "balance, against other regulatory criteria and considerations, the competitive implications of self-regulatory [actions]."[2] The executive branch warns that an agency "must ...propose or adopt a regulation only upon a reasoned determination that its benefits justify its costs."[3] The D.C. Circuit likewise

[1] *See, e.g.*, FINRA Regulatory Notice 14-02: Margin Requirements, at 3 (Jan. 27, 2014).
[2] *See* S. Rep. 94, 94th Cong., 1st Sess. (April 14, 1975) at 12-13
[3] *See also* Executive Order 13,563. § 1(b), 76 Fed. Reg. 3821 (Jan. 18, 2011)

holds that a party suffers "'constitutional injury in fact when agencies . . . allow increased competition' against them,"[4] and will overturn a rule where the Commission fails to conduct an adequate cost-benefit analysis.[5] Accordingly, past Commissioners have emphasized the critical importance of addressing a rule's costs and benefits.[6]

Notwithstanding this federal guidance, the Rule disproportionately burdens smaller and medium-sized broker dealers and favors broker dealers with regional bank affiliates that can purchase the same securities, but are not subject to FINRA's rules. Under the Rule, FINRA members must collect margin from counterparties. But, as regional banks are outside the scope of the Rule, they need not collect margin from their counterparties or subject their counterparties to mark-to-market margining. Where a counterparty is given the choice between posting margin to a FINRA member, or avoiding this obligation and associated costs by trading with a non-FINRA member, the less capital-intensive and expensive choice is obvious. The Rule provides regional banks and their broker-dealer affiliates to whom they can source inventory, a vast competitive edge over other FINRA members. And, unsurprisingly, customers have already taken steps to move their business accordingly.

The Rule also disproportionately burdens small-to-medium sized brokers by imposing a variety of costs that, as compared to larger players, are outsized relative to these brokers'

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[4] *Fin. Planning Ass'n v. S.E.C.*, 482 F.3d 481, 486 (D.C. Cir. 2007) (association had standing to challenge SEC rule exempting certain broker dealers from IAA; Congress sought to protect ability of bona fide investment advisers to compete on a level regulatory playing field); *Taxation with Representation of Wash. v. Regan*, 676 F.2d 715, 723 (D.C. Cir. 1982) (organization had standing to challenge IRS rule by demonstrating injury from the unequal application of the statute), *rev'd on other grounds*, 461 U.S. 540 (1997); *Haitian Refugee Ctr. v. Gracey*, 809 F.2d 794, 799 (D.C. Cir. 1987) ("drain on [an] organization's resources" is "concrete and demonstrable" injury).
[5] *See Chamber of Commerce of U.S. v. SEC*, 412 F.3d 133 (D.C. Cir. 2005); *Am. Equity Inv. Life Ins. Co. v. SEC.*, 613 F.3d 166 (D.C. Cir. 2010); *Bus. Roundtable v. SEC.*, 647 F.3d 1144 (D.C. Cir. 2011).
[6] *See* Feb. 9, 2007 speeches of Chairman Cox and Commissioners Atkins, Casey, and Nazareth at PLI SEC Speaks Conference; SEC Chairman Levitt's testimony on March 14, 1997 ("the Commission measures the benefits of proposed rules against possible anti-competitive effects, as required by the Exchange Act.")

revenues. Such costs include both the cost of capital (especially on introducing brokers who now face a double margin requirement) and new operational costs. For example, for dealers that engage in only a moderate amount of Covered Agency Transactions, the costs of evaluating new technology providers, building compliance systems, hiring new personnel, and implementing the margining system, are an extreme burden. Smaller broker dealers must decide whether they can survive in the TBA market under the Rule, or whether these implementation and compliance costs will prove uneconomical.[7] Larger dealers are better-equipped to internalize such operational costs. If the vast number of small and midsized brokers were to determine that it no longer makes economic sense to stay in the market under the Rule's new operational and capital costs, the market would be left in the hands of a small number of extremely large investment banks. FINRA has declined to explain how consolidation of the marketplace, with its inevitable reduction in liquidity, fulfills its duty to adopt rules that justly and equitably impact market participants.

The Commission should have rejected the Rule, as well, because the Rule's harm to smaller broker dealers outweighs its benefits. Introducing brokers generally operate on a riskless or extremely low-risk basis, matching long exposure with short exposure. Nonetheless, regulatory capital requirements and introducing brokers' margin arrangements with their clearing firms already impose substantial capitalization requirements in Covered Agency Transactions. Now, the Rule threatens to pile an additional, unnecessary capital burden—and the cost of that capital—onto these introducing brokers, disregarding the "riskless" nature of their trading position. Moreover, the Rule creates special problems for brokers trading with registered

[7] *See* Nov. 20, 2016 Letter from Charles M. Weber, Robert W. Baird & Co. Inc., to Robert W. Errett, Deputy Secretary, SEC, re: SR-FINRA-2015-036: Comments on the Proposed Amendment to FINRA Rule 4210, https://www.sec.gov/comments/sr-finra-2015-036/finra2015036-39.pdf.

investment companies, where the collateral cannot be repledged. Typically, the collateral posted by one party could be used by the counterparty to reduce or eliminate the counterparty's exposure. Because of unique requirements applicable to registered investment companies, however, margin posted by any such entity could not be re-posted by the broker to satisfy the Rule's requirements on MTM losses on the other side of the riskless trade. Consequently, to satisfy the Rule, the broker would need to acquire additional capital, despite a neutral trading position. The Rule thus adds another layer of unnecessary cost, and further harms smaller firms.

In addition, brokers acting on a riskless basis will be damaged by the Rule's demand for position liquidation when a counterparty fails to post margin. In this situation, the counterparty would not deliver the security to the broker, even if the broker, operating on a riskless basis, owes delivery of that security to a third party. This can significantly damage the innocent broker in cases of difficult-to-source, non-TBA securities, or shift the broker's losses in cases of available securities, albeit at higher prices. The Rule thus adds a new element of instability.

The Rule also worsens competitive dynamics by forcing smaller and medium-sized broker dealers to enter agreements for bilateral margining with market-dominant broker dealers. Trading with these major broker dealers is essential to market participation, and these major players can and do use their dominance to extract onerous terms and conditions on the smaller and medium-sized broker in such bilateral agreements. Moreover, since the Rule does not identify the party responsible for marking-to-market the MBS, the same group of major banks may claim marks that vary widely from the market price, imposing collateral obligations where none exist. Once more, the smaller and midsize firms bear extra costs of capital and compliance.

III. The Commission Lacked Authority To Approve Amended FINRA Rule 4210

A. Overview of Rule Margin Requirements

The Rule is an unauthorized and unreasonable exercise of the Commission's power to regulate margin on agency MBS. Because the Securities Exchange Act of 1934 defines agency MBS as "exempted securities," they have never been subject to margin regulation under § 7 of the Exchange Act.[8] Congress used § 7 to empower the FRB, and no other government entity, with authority to regulate margin, which is defined as the amount of credit that can be extended and maintained on any security <u>other than an exempted security</u> ("the Board of Governors of the Federal Reserve System shall, prior to the effective date of this section and from time to time thereafter, prescribe rules and regulations with respect to the amount of credit that may be initially extended and subsequently maintained on any security (<u>other than an exempted security</u> or a security futures product)"). [9] FINRA Rule 4210(a) (6) defines exempted securities as does the Exchange Act—to encompass agency MBS.[10] Accordingly, the Covered Agency Transactions are comprised almost entirely of MBS that have never been subject to margin regulation under Section 7—until now.

B. Congress Did Not Authorize FINRA or the Commission to Regulate Margin, Let Alone Margin on Exempted Securities

The text of Exchange Act § 7 succinctly identifies the FRB, and only the FRB, as responsible for regulating margin.[11] The legislative history of § 7 likewise indicates that Congress never intended the Commission to administer margin regimes. When Congress passed the Exchange Act, it acknowledged the FRB's "unique and outstanding expertise" in regulating

[8] Congress defines agency MBS as "exempted securities." *See* 15 U.S.C. §§ 78c(a)(12) ("exempted securities" include "government securities"); 78c(a)(42).
[9] *See* 15 U.S.C. § 78g (emphasis added).
[10] *See* Sec. Exch. Act Release No. 78081, at 3-4 (June 15, 2016) ("Release No. 78081").
[11] 15 U.S.C. § 78g(a).

credit.[12] Congress's "underlying theory of [the Exchange Act] with respect to the control of credit is . . . all speculative credit should be subjected to the central control of the Federal Reserve Board as the most experienced and best equipped credit agency of the Government."[13]

Congress prohibits both the FRB and the Commission from regulating exempted, agency MBS, which comprise the Covered Agency Transactions.

C. The Amended Rule is an Unreasonable Construction of Exchange Act § 7

The Commission has failed to adequately explain the Rule's sudden departure from the decades-old regulatory regime wherein agency MBS have not been subject to § 7's margin requirements. "A statutory interpretation ... that results from an unexplained departure from prior [agency] policy and practice is not a reasonable one."[14] FINRA's justification that "the growth of the TBA market" and "number of participants and the credit concerns that have been raised in recent years" is similarly insufficient.[15] The perceived need for "more comprehensive regulation" does not entitle the Commission to reinterpret the text of the Exchange Act.[16]

Also, the Commission may not interpret "exempted securities" to include agency MBS in some provisions of the Exchange Act, but not in others. The courts in this country have long adhered to the "basic canon of statutory construction that identical terms within an Act bear the same meaning," or, stated differently, a word must share the same meaning throughout all

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[12] *Collateral Lenders Comm. v. Bd. of Governors of Fed. Reserve Sys.*, 281 F. Supp. 899, 904 (S.D.N.Y. 1968); *see also* H.R. REP. 98-994, at 47-48 (the FRB "has primary rulemaking authority" with respect to margin, while the "Commission and the securities self-regulatory organizations enforce [the FRB's] rules.").
[13] H.R. Rep. 73-1383 at 7.
[14] *See Northpoint Technology, Ltd. v. FCC*, 412 F.3d 145, 156 (D.C. Cir. 2005).
[15] FINRA Regulatory Notice 14-02 at 1, 3 (Jan. 27, 2014).
[16] *Goldstein v. SEC*, 451 F.3d 873, 882 (D.C. Cir. 2006); *see also Util. Air Reg. Grp. v. EPA*, 134 S. Ct. 2427, 2446 (2014) ("[A]n agency may not rewrite clear statutory terms to suit its own sense of how the statute should operate.").

provisions of a statute.[17] The Supreme Court has rejected "forced and unconventional" attempts to imbue a phrase used more than once in the same statute, with different meanings.[18]

Here, the Rule contravenes this basic principle of statutory construction and Supreme Court precedent. The Exchange Act defines "exempted securities" to include agency MBS in § 3(a) (12) and § 7. Rule 4210(a)(6) defines "exempted securities" the same way, adopting the meaning in § 3(a)(12) of the Exchange Act. But notwithstanding the Rule's definition of "exempted securities" to include agency MBS, according to § 3(a)(12), the Rule seeks to regulate agency MBS—which, per their definition—are prohibited from regulation under § 7. It is plainly unreasonable for FINRA and the SEC to interpret "exempted securities" so that its dual definitions, in the same statute, have opposite meanings.

IV. Conclusion

For the foregoing reasons, the Commission should repeal the amendment to Rule 4210. We would appreciate the opportunity to further discuss these issues with the Commission or its staff, and to respond to any questions that may be posed.

Respectfully submitted,

Thomas J. Fleming

cc: Brean Capital, LLC

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[17] *Estate of Cowart v. Nicklos Drilling Co.*, 505 U.S. 469, 479 (1992).
[18] *Id.* at 478-79; *Goldstein*, 451 F.3d at 882.