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A business of Prudential Financial, Inc.

By Electronic Submission

February 11, 2016

Mr. Robert W. Errett
Deputy Secretary
Securities and Exchange Commission
100 F Street NE.
Washington, DC 20549-1090
Via email *rule-comments@sec.gov*

Re: SR-FINRA-2015-036: Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Order Instituting Proceedings To Determine Whether To Approve or Disapprove Proposed Rule Change To Amend FINRA Rule 4210 (Margin Requirements) To Establish Margin Requirements for the TBA Market, as Modified by Partial Amendment No. 1

Dear Deputy Secretary Errett,

As one of the largest multifamily housing lenders in the country, Prudential Mortgage Capital Company, LLC (PMCC)[1], we would like to thank you for the opportunity to comment on Partial Amendment No. 1 to Rule 4210 in the January 21, 2016 *Federal Register* Notice titled "Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Order Instituting Proceedings To Determine Whether To Approve or Disapprove Proposed Rule Change To Amend FINRA Rule 4210 (Margin Requirements) To Establish Margin Requirements for the TBA Market, as Modified by Partial Amendment No. 1." Partial Amendment No.1 (the "Proposed Rule") indicates that the U.S. Securities and Exchange Commission (SEC) and the Financial Industry Regulatory Authority, Inc. (FINRA) understand there are substantial differences between multifamily mortgage backed securities (MBS) and the single family "To-Be-Announced" (TBA) market. We welcome the decision to seek additional input on the Proposed Rule.

[1] PMCC, a subsidiary of Prudential Financial, Inc., is a commercial mortgage lender with access to a variety of capital sources to meet a wide range of borrower needs. Among other products, the company originates commercial mortgage loans for various programs overseen by the government sponsored entities (GSEs)—Fannie Mae and Freddie Mac—and the Federal Housing Administration (FHA). These loans provide developers and property owners with the funds needed to acquire, refinance, rehabilitate, and construct multifamily properties, specialized properties (i.e., affordable housing, student housing, and senior housing) and healthcare facilities (i.e., hospitals, nursing homes, assisted living, etc.).

While PMCC appreciates the SEC and FINRA's recognition that a "one-size-fits-all" approach to margining for MBS is not realistic, we are still concerned that the Proposed Rule does not address the potentially serious consequences that *any* margining of multifamily MBS could have on the multifamily housing market. We urge the SEC and FINRA to support a full exemption for multifamily MBS in the final rule.

The Proposed Rule require sellers[2] of mortgage backed securities (MBS) to post a margin of two percent of the value of forward MBS[3] with any counterparty that is a FINRA broker-dealer plus a daily mark-to-market variation margin. The Proposed Rule indicates that the amendment to Rule 4210 is necessary because of the growth in volume in the "To-Be-Announced" (TBA) market, the number of participants in the TBA market, and credit and systemic risk concerns that have arisen in the housing finance market since the recession. The Proposed Rule would apply not only to the single-family TBA market but also to individual multifamily loans[4] that support Ginnie Mae and Fannie Mae MBS. It attempts to distinguish multifamily MBS by giving the FINRA broker-dealer the option, in its sole discretion, to elect to unilaterally waive the margin requirement in the event MBS are issued in conformity with certain Fannie Mae, Freddie Mac or Federal Housing Administration (FHA) programs and the FINRA broker-dealer "makes a written risk limit determination for each such counterparty that [the FINRA broker-dealer] shall enforce …" However, the Proposed Rule does little to mitigate the serious concerns created by margining. PMCC feels that any margining on multifamily MBS would likely result in decreased liquidity in the market, fewer new multifamily—particularly affordable and workforce—units, decreased competition, and increased costs to lenders, borrowers, and renters.

As we discuss in more detail below, we believe the SEC and FINRA should support a full exemption of multifamily MBS from the final margining rule because (i) the potential systemic risks to the financial markets that are perceived to exist in the TBA market are not present in the multifamily MBS market due to the much smaller size of this market, (ii) the existing structure of multifamily MBS transactions already provides for ample risk mitigation and effectively provides substantially the same protection that would be offered by FINRA's proposed margin requirements, and (iii) the inadequate study on the potential negative economic effects of the Proposed Rule.

Our comments below address the reasons for fully exempting multifamily MBS from margining as well as PMCC's specific responses to the SEC's questions contained in the *Federal Register* January 21, 2016 notice.

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[2] We note that this margin requirement is one way in favor of the MBS purchaser. The proposed rule does not contain any requirement in which the purchaser (FINRA's constituency – the broker-dealers) would be required to post a margin in favor of the seller, which is contrary to the recommendation of the Federal Reserve Bank of New York's Treasury Market Practices Group that the margins should apply to both the seller <u>and</u> the broker-dealer.

[3] Mortgage bankers, which FINRA defined to capture real estate lenders, would be exempted from the 2 percent requirement.

[4] The Proposed Rule would apply to MBS trades backed by multifamily loans and healthcare facilities. Our comments in this letter apply equally to multifamily MBS and healthcare facility MBS.

EXEMPT MULTIFAMILY MBS FROM THE PROPOSED RULE

Multifamily MBS Distinguished from Single-Family MBS

Trading multifamily MBS is vastly different than trading single-family MBS. In a typical forward settling transaction in the single-family market, the MBS seller is agreeing to transfer a pool of single-family MBS that have not been identified. In other words, there are no loans backing the MBS at the time of the trade. These single-family pools are typically identified or “announced” only 48 hours before settlement. In contrast, the actual loan is specifically identified when the multifamily MBS seller and buyer enter into a trade confirmation.[5] Essentially, a multifamily trade is an asset sale relating to a single MBS backed by a single loan with an identified borrower on terms specified at the time of the trade. As such, there is nothing “to be announced” about a multifamily MBS trade. The security, loan, borrower, property, loan terms, and terms of sale are all spelled out in the trade confirmation.

Not only is the multifamily loan underlying the MBS identified at the time of the trade, but it has already been subjected to extensive underwriting. The borrower and the property securing the loan will have been underwritten in accordance with the applicable (Fannie Mae or FHA) underwriting standards.

Prior to the trade, the lender and borrower typically enter into a conditional loan commitment. Under this commitment, the lender agrees to make the loan and the borrower agrees to close the loan as long as the remaining closing conditions are satisfied. The commitment is a legally binding contract.

The interest rate for the loan is typically locked following the delivery of the commitment. This rate lock allows the borrower to mitigate its exposure to changes in the interest rate prior to the loan closing, but creates interest rate risk for the lender. Under the terms of the rate lock, the borrower delivers a Good Faith Deposit[6] to the lender, which would be surrendered to the lender in the event the loan does not close. In addition, the borrower may be required to pay additional damages in the event of a failed closing under certain conditions.

In order to hedge its risk, the lender enters into a forward commitment (the trade confirmation) to deliver an MBS backed by the loan to a counterparty purchaser, often a FINRA broker-dealer, by a specified date, at which time the purchaser will acquire the MBS and some or all of the proceeds of this MBS sale will be used to reimburse the lender’s advance of funds to the borrower at the loan closing. In a multifamily MBS transaction, the purchaser is afforded economic protection against the risk of both failed trades and delayed deliveries. If the lender fails to deliver the MBS as promised, the Good Faith Deposit would be paid to the purchaser, mitigating the risk of either a borrower’s or a lender’s default. In addition, if the lender fails to deliver the MBS by the date specified in the trade commitment, the purchaser may be entitled to receive extension fees. As a result of these practices, which create meaningful incentives for both the borrower and the lender to perform, failed trades in the multifamily MBS market are exceptionally rare.

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[5] The Trade Confirmation is a legally binding contract entered into by the MBS seller and buyer containing all of the terms of the sale.

[6] The Good Faith Deposit ranges from 0.5 percent to 2.0 percent depending upon the loan program.

Size of Multifamily Market

Concerns expressed in the Proposed Rule about potential systemic risks are not present in the multifamily market. While the single-family TBA MBS market has an annual trading volume of approximately $1 trillion, with a weekly volume outstanding of approximately $100 billion, the market for multifamily MBS is a small fraction of this amount with an annual trading volume of only around $50 billion, just 5 percent of the TBA market, and a weekly outstanding volume of only about $3.56 billion (or 3.5 percent of the TBA market). We note also that there are vastly fewer multifamily Fannie Mae and FHA lenders than there are single-family lenders, in large part due to the extensive Federal Housing Finance Agency (FHFA) and FHA oversight over multifamily lenders that conduct business with Fannie Mae and Ginnie Mae respectively, including regular audits and minimum capital requirements. The size and regulation of the multifamily market would prevent it from having significant impact on the U.S. financial system in the unlikely event of a severe and unprecedented market disruption.

In fact, the Proposed Rule acknowledges that the multifamily market constitutes a small portion of the MBS market "which suggests multifamily and project loan securities are less likely to pose issues of systemic risk." It goes on to state that it "believes that it is appropriate to require that members make and enforce written risk limit determinations for their counterparties in multifamily and housing securities." The Proposed Rule further asserts that this "requirement would serve to help prevent over-concentration in these products." While we very much appreciate the Proposed Rule's concerns over risk limits and diversification, FINRA has tools at its disposal that could directly accomplish these goals without negatively impacting lenders, borrowers, renters and the multifamily market as a whole. For example, FINRA members could simply be required to operate within certain risk limits and diversification requirements. This would accomplish the Proposed Rule's objectives without putting the market at risk.

Risk Mitigation

As noted above, at the time a multifamily MBS trade is confirmed, significant protections are in place to insulate the MBS purchaser from credit and counterparty risk: (i) the loan, the borrower, and the property are already specifically identified and have been underwritten in accordance with Fannie Mae or FHA standards, (ii) the borrower and the lender are contractually bound to close the loan as long as the closing conditions are satisfied, (iii) the borrower has paid a Good Faith Deposit and is often bound to pay additional damages in the event of a failed trade, (iv) in the event of a failed trade, the Good Faith Deposit[7] would be surrendered to the prospective multifamily MBS purchaser,[8] and (v) in the event the trade is delayed, extension fees may be payable to the purchaser. The existing multifamily structural risk mitigation tools address most, if not all, of the concerns that the Proposed Rule seeks to deal with in the MBS markets. Therefore, any margin requirements would only add costs and unnecessary friction to the multifamily market.

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[7] We note that the Good Faith Deposit has the same effect as the posting of a margin.

[8] There may be the possibility of additional damages under the trade confirmation depending upon the cause of the fail.

Insufficient Analysis on the Consequences of the Rule Change

The Proposed Rule has offered no clear rationale for including multifamily forward MBS in any margining regime, having scoped in the multifamily market through a single footnote with no further information. The Proposed Rule does not include any type of analysis on the potential negative impacts to the multifamily market[9] despite the October 2015 draft rule[10] including an extensive analysis that focuses on the single-family market. Imposing such a dramatic change in this market without performing the necessary analysis to understand the potential impact on the multifamily industry would be imprudent.

Potential Rule Impacts

We are concerned that the Proposed Rule would result in greater costs to multifamily lenders, borrowers, and consumers without any meaningful, commensurate benefit to the integrity of the financial markets.

If the Proposed Rule is implemented, it could adversely affect PMCC's (and other lenders') ability to make multifamily and healthcare facility loans secured by stabilized properties and could decrease or potentially end PMCC's ability to provide construction financing for new developments or substantial rehabilitations. Imposing margins on multifamily MBS ties up capital and could reduce a lender's liquidity for a period of some 30 to 90 days for permanent multifamily loans and potentially for as long as two years or more for construction loans, if the lender internalizes these costs. The economic effect of these margin requirements could easily lead lenders to view construction lending as cost prohibitive, since very few lenders would be able to afford to maintain margin on the full value of a loan for a period of 18 to 24 (or more) months. It is conceivable that smaller lenders in particular could be forced out of the lending market entirely. For loans that might still be made, the margining would increase the cost of capital necessary to complete MBS transactions and this additional cost would almost certainly increase the interest, fees, and other costs payable by the borrower. Ultimately, these additional costs will likely be borne by consumers, in the form of higher rents on apartments.

Most significantly, the Proposed Rule seems likely to make it more difficult for borrowers to complete affordable[11] and workforce housing deals at a time when demand for affordable rental housing is at an all time high. These transactions tend to be extremely complex, often requiring multiple sources of both debt and equity capital in order to succeed. Any margining would indirectly increase the capital necessary to complete an affordable or workforce multifamily deal, escalating the risk that the deal could potentially fall through, and adversely affect the availability of affordable housing at a time when it is critically needed.

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[9] For example, the Proposed Rule did not include any type of cost-benefit analysis.

[10] 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," Release No. 34-76148; File No. SR-FINRA-2015-036, U.S. Securities and Exchange Commission, October 14, 2015, http://www.sec.gov/rules/sro/finra/2015/34-76148.pdf.

[11] Affordability is generally understood to mean that families are spending up to 30 percent of their incomes on rents. As of 2013, HUD estimates that there are over 7.7 million renters with worst case housing needs, i.e., spending over 50 percent of their incomes on rent. Office of Policy Development and Research, "Worst Case Housing Needs: 2015 Report to Congress," Department of Housing and Urban Development, April 2015, p. iii, https://www.huduser.gov/portal//Publications/pdf/WorstCaseNeeds_2015.pdf.

Fewer, more expensive multifamily deals would result in increased rent burdens on consumers. Nationally, multifamily rents have already grown 16 percent over the last five years per Fannie Mae.[12] The additional borrower costs resulting from margin requirements would likely be passed on to the renters to make the deals feasible, which would result in yet higher rents. This comes at a time when demand for affordable housing greatly outpaces supply. The Department of Housing and Urban Development (HUD) estimates there are 65 units available for every 100 households seeking affordable housing.[13]

Difficulty in Determining the Margin

Not only is the mark-to-market margin in the Proposed Rule unnecessary and potentially damaging for the multifamily market, it would be extraordinarily difficult to implement. Unlike single-family MBS—which are backed by homogenous pools of loans that are fungible, and as a result can be and are traded regularly and as such, are routinely valued by the market—each multifamily MBS is unique. Multifamily MBS are typically sold via auction to a limited number of potential buyers. Bids inevitably vary among bidders and differ based upon the security being offered and the buyer's needs at the time of the offering. As a result, there is no existing, ready mechanism to determine the change in a particular MBS's value from time to time, let alone from day to day. Determining the correct margin would be a difficult process at best, most likely leading to disputes between lenders and FINRA broker-dealers, resulting in wasted time and money.

PROPOSED RULE DOES NOT ADDRESS SIGNIFICANT ISSUES

We note that the Proposed Rule attempts to distinguish the multifamily MBS market from the single family TBA market based on feedback from the industry. After a thorough review of the Proposed Rule, however, PMCC does not believe the conditional exemption is a sufficient solution for addressing the many concerns associated with margining multifamily MBS:

1. *The determination of whether a margin requirement would be required for a given multifamily MBS trade would be solely determined by the FINRA broker-dealer*. This determination would apparently be based upon a written determination of a risk limit for each counterparty that would be enforced by the FINRA member. There is no objective standard for when a margin would be required. This could result in entirely inconsistent requirements for whether and when a margin would be required. It is certainly foreseeable that this would result in inconsistent practices within the industry and, importantly, would leave the lender in the dark as to whether and when a margin would be required. As discussed above, the underlying loan terms are largely put in place before the multifamily MBS trade is made. It would be very difficult for a lender to properly structure a transaction without knowing the costs that would be imposed.

2. *The margin requirement only goes one way*. The Proposed Rule only accounts for the FINRA broker-dealer and does not serve to protect lenders or the multifamily market. In the event the FINRA broker-dealer believes that it made an unfavorable trade, it would have the ability to

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[12] Economic and Strategic Research, "Multifamily Market Commentary – December 2015," Fannie Mae, December 2015, p. 2, http://fanniemae.com/resources/file/research/emma/pdf/MF_Market_Commentary_121515.pdf.
[13] Office of Policy Development and Research, p. iii.

require additional security from the lender. However, if the FINRA broker-dealer ends up with the potential for additional profit (and resulting lost profit for the lender), there is no requirement that the FINRA broker-dealer post additional security for the lender. This is contrary to the recommendations of the Federal Reserve Bank of New York's Treasury Market Practices Group.

3. *The Good Faith Deposit is completely ignored*. As discussed above, the posting of the Good Faith Deposit provides the security that the Proposed Rule is seeking. The Proposed Rule does not appear to take this fact into account. In addition, the Proposed Rule does not specify if the Good Faith Deposit would be *in addition* to the posting of the margin. There is no rationale for requiring both the margin and the Good Faith Deposit for one party in a two-party contract entered into by sophisticated parties.

4. *Determining a mark-to-market margin on a daily basis is subjective and opaque.* As mentioned above, there is no ready mechanism for determining a mark-to-market margin in the multifamily market. Doing so on a daily basis is not realistic. This type of requirement would be extremely difficult and expensive to implement and would undoubtedly result in unnecessary disagreements and potentially litigation and consequently wasted money.

PMCC RESPONSES TO SEC QUESTIONS

1. Will the proposed rule change, as modified by Partial Amendment No. 1, affect the operation and structure of the TBA markets as it exists today? If so, how?

PMCC does not have any comments as to whether the Proposed Rule would affect the single family TBA markets. However, the Proposed Rule could negatively impact the operation and structure of the existing multifamily mortgage market in a potentially profound manner. As discussed in detail above, margining would likely result in additional costs to multifamily lenders and borrowers, as well as indirectly to consumers through higher rents. Lender liquidity would also be limited. This may reduce the number of loans a lender originates as well as potentially force small and medium multifamily lenders out of the market. Fewer loans would shrink the already small size of the multifamily MBS market and limit the investments available to broker-dealers and other investors.

The Proposed Rule may also lead to mortgage pricing uncertainty in the marketplace. Broker-dealers are not required to share their risk policy and procedures with lenders and without objective standards margining may not be implemented uniformly. Unless the broker-dealers are completely transparent, it would be difficult for lenders to determine when a broker-dealer might require a margin in connection with a given multifamily MBS trade. Lenders will have difficulty structuring mortgage costs and fees, as the transaction structure is typically put in place before the MBS trades are put in place. Similar multifamily mortgage prices and fees could vary significantly depending on the broker-dealer and their margining policies, which could lead to confusion when lenders are competing in the market for borrowers, disrupting existing lending practices.

Although the Federal Reserve Bank of New York's Treasury Market Practices Group recommended that the margins should apply to both the seller *and* the broker-dealer, the margin is only required one way in favor of the MBS purchaser, in this case the broker-dealer. The proposed rule does not require the broker-dealer to have any "skin in the game." Short of any applicable terms in the Master Securities Forward Transaction Agreement (MSFTA) between the lenders and the broker-dealers (if one exists), there are no other consequences for the broker-dealer in the sales process, which may disincentivize lenders to sell securities to broker-dealers and could fundamentally change the players and, potentially, the mechanisms for selling these securities in the market.

These consequences do not have any apparent commensurate benefit.

2. What are commenters' views with respect to the benefits and costs of the proposed rule change, as modified by Partial Amendment No. 1? What implementation and ongoing costs will result, if any, from complying with the proposed rule change, as modified by Partial Amendment No. 1?

As discussed above, it is very difficult for us to see any benefit to imposing a margin on multifamily MBS trades. The margin would result in additional costs that would, in all likelihood, ultimately be passed down to the renter and borrower. These additional costs could result in decreased availability of workforce and affordable housing.

3. Will the proposed rule change, as modified by Partial Amendment No. 1, affect FINRA member firms differently based on their size (i.e., small, medium or large firms)? If so, how? Will the proposed rule change, as modified by Partial Amendment No. 1, create competitive advantages or disadvantages for member firms based on their size? If so, how?

In our view, this is all very uncertain, but it is likely that the ripple effects of margining in the multifamily market would be felt unevenly.

4. What are commenters' views on the impact of the proposed rule change, as modified by Partial Amendment No. 1, on other affected parties, such as non-member firms and other market participants?

PMCC is concerned that the Proposed Rule could result in greater costs to multifamily lenders, borrowers, and consumers without any meaningful, commensurate benefit to the integrity of the financial markets. These additional costs could result in decreased availability of workforce and affordable housing.

5. What are commenters' views on the exception for multifamily housing and project loan securities in the proposed rule change, as modified by Partial Amendment No. 1? Does the proposed exception for multifamily and project loan securities pose any risks to FINRA members, as well as other market participants? If so, please describe these risks?

As discussed in detail above, PMCC believes that margining is out of place in the multifamily MBS market and could have result in significant negative consequences. Allowing a FINRA broker-dealer to solely determine whether and under what circumstances a margin would be imposed does not change our view. We continue to support a full exemption of multifamily MBS from the Proposed Rule, as we believe the exemption would not pose meaningful risks to FINRA members or other market participants. Multifamily MBS are stable and reliable investment products with low default rates and even lower numbers of multifamily MBS sales that do not close.

6. What are commenters' views on the implementation time required to comply with the proposed rule change, as modified by Partial Amendment No. 1?

PMCC has no comments to contribute at this time.

Conclusion

While multifamily mortgages issued in conformity with Fannie Mae and Ginnie Mae guidelines would not be subject to uniform margining requirements, the Proposed Rule could still have a significant impact on the practices of the multifamily lending industry. The multifamily market has a number of safeguards already in place that help mitigate the risks to broker-dealers and other investors, which address the Proposed Rule’s major concerns highlighted in the January 21, 2016 *Federal Register* Notice. PMCC strongly urges the SEC and FINRA to support completely excluding multifamily forward MBS from the margining under the Proposed Rule instead of providing only a subjective, conditional exemption.

We appreciate the opportunity to comment on the Proposed Rule. If you would like to discuss this issue further, please contact Lauren Sarper in the Prudential Financial, Inc. External Affairs office at [redacted] or ([redacted] Thank you for the kind consideration of our comments.

Sincerely,

Mike McRoberts
Managing Director

cc: The Honorable Mary Jo White, Chair, U.S. Securities and Exchange Commission
The Honorable Kara M. Stein, Commissioner, U.S. Securities and Exchange Commission
The Honorable Michael S. Piwowar, Commissioner, U.S. Securities and Exchange Commission
Stephen Luparello, Director, Division of Trading and Markets, U.S. Securities and Exchange Commission
Bill Wollman, Executive Vice President, Member Regulation—Risk Oversight and Operational Regulation, Financial Industry Regulatory Authority