MEMORANDUM

TO: File Number SR-FINRA-2015-036

FROM: Jessica Mark
Law Clerk
Office of Financial Responsibility, Division of Trading and Markets
U.S. Securities and Exchange Commission

DATE: March 21, 2016

RE: Meeting with Brean Capital, LLC

On March 21, 2016, Commission staff met with representatives of Brean Capital, LLC to discuss Financial Industry Regulatory Authority, Inc. ("FINRA") 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 (Release No. 34-76908).

Commission staff at the meeting were Michael Macchiaroli, Thomas McGowan, Randall Roy, Timothy Fox, Sheila Swartz, and Jessica Mark from the Division of Trading and Markets.

The Brean Capital attendees at the meeting were Robert Fine and Robert Tirschwell, Mitchell Raab (Olshan, counsel assisting Brean Capital).

March 21, 2016

Brean Capital - SEC Discussion on Rule 4210

2:00 – 2:15

Introductions

2:15 – 2:45

Discussion on the impacts of 4210 on the marketplace.

The rule, as proposed, will lead to fewer regional dealers, banks and mortgage originators participating in the Mortgage Backed Securities market.

The result will be less liquidity in the marketplace, wider bid/offer spreads on secondary market securities, and ultimately higher borrowing costs to homeowners.

Mortgage rates, set by originators, are ultimately determined by what price investors are willing to pay for the loans, or securities, in the secondary marketplace. To the extent that MBS in the secondary market trades less efficiently, interest rates on new mortgages will likely increase on a relative value basis.

Regional dealers provide a great deal of liquidity in the MBS market, especially the secondary market, but they typically don't have balance sheet to support the greater burden of additional margin posting.

Regional dealers are not typically involved in trading large amounts of forward settling TBA securities.

They tend to serve the role of liquidity provider in seasoned, secondary market bonds by matching buyers and sellers in less liquid MBS, often using little balance sheet, and taking minimal risk, in the process. They also tend to serve smaller mortgage originators.

Many regional dealers simply will not have the capital available to meet the new margin requirements, or the wherewithal to build and maintain a margin department, and will be forced out of the market.

Larger market participants will be reluctant to post collateral to smaller institutions.

Large institutions dictate their own terms for an MSFTA. Some do not allow further hypothecation of posted collateral. Any 40 Act funds participating in the market cannot allow further hypothecation. Accordingly, the rule drives a permanent shortage of collateral for regional dealers.

All dealers will have less capital available to provide liquidity, as they'll have to set aside capital to meet realized and potential margin calls.

The marketplace will move away from many large and small participants and consolidate to only a handful of the largest, too big to fail institutions.

The MBS market recently loss the full or partial participation of many large banks, including Deutsche Bank, Credit Suisse, UBS, Barclays, RBS, Societe Generale and several others.

Though liquidity and financing is becoming scarcer, the full impact hasn't yet been felt, as hedge funds, acting like dealers, have been opportunistic buyers of MBS. But they are not market makers, and they will likely contribute to volatility in certain scenarios, as they do not have permanent capital.

The reduction in competition, by consolidating the market to a handful of huge participants, will not only lead to wider bond spreads and higher borrowing costs, but ironically also creates greater systemic risk than exists today.

In looking at the practical concerns in implementing the margin rule, many issues come up.

Inherent unreliability of marks in the marketplace on one off, specified pools, can and will lead to incorrect margin calls. Brean Capital just experienced such a situation with another dealer.

Erroneous margin calls will be exacerbated in a time of volatility, and will absolutely lead to even greater volatility, as parties will be forced to sell or will be closed out at the most inopportune times.

This problem of unreliable marks and erroneous margin calls will likely be exacerbated when bilateral margining results in fewer participants in the market.

The proposed close out requirement raises other issues in the secondary MBS market.

Older, seasoned securities develop unique characteristics. Closing out a trade can cause a chain reaction of problems. For example, if a dealer is forced to close out one side of a trade, but has already sold the security to a third party as they often do, the dealer will have to find a substitute security to deliver to the third party. Now the dealer is burdened with the challenge of finding a suitable substitute security to deliver, which may be difficult, and is at the mercy of the third party to agree to the substitution.

This can be a long process, and may result in monetary damages to the dealer who was forced to close out the trade. Had the trade not been closed out, it likely would have settled.

In the case of Lehman Brothers, where Lehman stood in the middle of multi Billon Dollars of trades, the ultimate parties were brought together, and the trades were ultimately settled, with relatively little disruption to the MBS market. That wouldn't have been the case if Lehman's counterparties arbitrarily closed out their trades with Lehman. In a marketplace where counterparties are inextricably linked, the notion of close out actually creates more systemic risk than reducing it.

<u>Solutions to Reduce Market Risk</u>

Require most, if not all, MBS securities to settle on a centralized clearing exchange, where margin can be posted/collected in an orderly and efficient fashion.

MBSCC members, or firms who clear through MBSCC members, post collateral in respect of cleared trades, which are netted against all other trades of such party on the centralized clearing exchange, thus reducing the overall collateral requirement to an amount that is appropriate for the aggregate level of risk to a particular institution.

Currently, only certain MBS trades (TBA trades and trades of fixed rate specified pools) are settling through MBSCC.

If MBSCC included Adjustable Rate GNMA's, FNMA's and FHLMC's and GNMA HECM's, and participants trading them were required to be netting members, a major concern of forward risk would be taken off the table.

Ultimately, all mortgage bond trades should be required to settle and net on a centralized clearing exchange.

This would result in a significantly more efficient deployment of capital than bilateral collateral posting, which, without netting, is insensitive to the true risk posed by a party's aggregate open trades, and would require total capital from dealers that is disproportionately in excess of the risk.

This alternative would also be a safer and more cost effective approach than requiring dealers to move funds around daily, possibly for weeks at a time on just a single transaction, and putting the dealer at risk to an institution that could fail, taking the dealer's posted collateral with it, and leaving the dealer with an open trade.

Until the universe of MBS securities settles on a centralized clearing exchange, limit the margin requirements to only true TBA securities, and to Specified securities, including CMO's *only* in the case of trades whereby the settlement date extends beyond the next available "good day" settlement date.

TBA securities are easily priced, reducing the risk of erroneous margin calls, and they are also easily replaced in the event of a close out.

2:45 – 3:00

Questions