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May 2, 2016

VIA ELECTRONIC SUBMISSION

Elizabeth M. Murphy, Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of Amendment No. 2 and Designation of a Longer Period for Commission Action on Proceedings to Determine Whether to Approve or Disapprove 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 and 2

Secretary Murphy:

On behalf of the eleven Federal Home Loan Banks (the "**FHLBanks**"), we appreciate this opportunity to comment on the proposed amendments to Financial Industry Regulatory Authority ("**FINRA**") Rule 4210, as modified by Partial Amendment Nos. 1 and 2, to require the margining of certain agency mortgage-backed securities (the "**Proposed Rule**").[1]

The FHLBanks have submitted comments to FINRA and the SEC throughout FINRA's rulemaking process to amend Rule 4210.[2] FINRA has failed to adequately address two specific

[1] For the avoidance of doubt, unless otherwise defined, capitalized terms used in this letter have the meanings afforded to them in the Federal Register releases for the: (1) initial version of the Proposed Rule, 80 Fed. Reg. 63,603 (Oct. 20, 2015) (the "**Proposed Rule Release**"); (2) January 13, 2016 amendment of the Proposed Rule, 81 Fed. Reg. 3532 (Jan. 21, 2016) (the "**First Amendment Release**"); and (3) March 21, 2016 amendment of the Proposed Rule, 81 Fed. Reg. 22,347 (April 15, 2016) (the "**Second Amendment Release**").

[2] *See* (1) Letter of the Federal Home Loan Bank of Indianapolis on behalf of the FHLBanks in reference to Proposed Amendments to FINRA Rule 4210 for Transactions in the TBA Market, dated April 4, 2014 ("**FHLBanks Letter 1**"), *available at* https://www.finra.org/sites/default/files/NoticeComment/p479813.pdf ; (2) Letter of the Federal Home Loan Banks in reference to 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

comments that the FHLBanks raised previously, namely that the Proposed Rule should be amended to (i) require two-way margining for Covered Agency Transactions and (ii) permit a FINRA member's counterparty to segregate any required maintenance margin posted to the FINRA member with an independent third-party custodian.[3] In light of this, and for the reasons discussed below, the FHLBanks respectfully request that the SEC disapprove the Proposed Rule.

1. Background

In response to the FHLBanks' comments in support of two-way margining and the segregation of required maintenance margin, FINRA has repeatedly responded that it would not be appropriate to adopt such recommendations as part of the Proposed Rule. However, FINRA has failed to explain its reasoning for these conclusions. On the issue of two-way margining, FINRA has responded that it "does not propose to address such a requirement at this time as part of the proposed rule."[4] And on segregation of posted margin, FINRA provided a similar response, stating that it would be best addressed in separate rulemaking or guidance, as appropriate.[5]

2. Basis for Disapproval of the Proposed Rule.

Pursuant to Section 15A of the Securities Exchange Act of 1934 (the "**Exchange Act**"), FINRA's rules must, among other things, generally "protect investors and the public interest."[6] The Securities and Exchange Commission ("**SEC**"), when considering whether to disapprove a registered securities association's (an "**RSA**") proposed rule change, must find that the proposed rule change is inconsistent with the provisions of the Exchange Act and SEC rules and regulations promulgated thereunder that are applicable to the RSA.[7] Accordingly, if an RSA's

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Margin Requirements for the TBA Markets, dated November 10, 2015 ("**FHLBanks Letter 2**"), *available at* https://www.sec.gov/comments/sr-finra-2015-036/finra2015036-47.pdf; and (3) Letter of the Federal Home Loan Banks in reference to 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 Markets, dated February 11, 2016 ("**FHLBanks Letter 3**"), *available at* https://www.sec.gov/comments/sr-finra-2015-036/finra2015036-81.pdf.

[3] To our knowledge, FINRA has not provided an explanation as to why it is inappropriate to require the segregation of a customer's collateral as a part of the Proposed Rule. We acknowledge FINRA's indication, in the Proposed Rule Release, that requiring two-way margining could "impose substantial additional burdens on members, or otherwise raise issues that are beyond the scope of the proposed rule change" and FINRA's general support of two-way margining (Proposed Rule Release at page 63,620). However, FINRA does not specifically identify the burdens and issues that two-way margining would impose on FINRA-members, nor does it take into account the benefits that two way margining would afford to non-FINRA members and the mortgage-backed securities market generally, namely decreased credit exposure to a FINRA member's default.

[4] *See* First Amendment Release at page 3,540 and Second Amendment Release at page 22,357.

[5] *See id.* at page at 3,544 and 22,357, respectively.

[6] 15 U.S.C. § 78*o*-3(b)(6).

[7] 15 U.S.C. § 78s(b)(2).

proposed rule change is inconsistent with its mandate to generally protect the public interest and investors, the SEC has authority to disapprove it.

In the FHLBanks' view, for the reasons discussed below, FINRA's refusal to incorporate the requested protections for investors in Covered Agency Transactions into the Proposed Rule reflects FINRA's interest in protecting its members rather than the general public interest and investors. The SEC should disapprove the Proposed Rule on this basis.

a. The Proposed Rule does not fully implement the recommendations it purports to codify.

The Proposed Rule is purportedly intended to codify a recommendation to margin mortgage-backed securities that was issued by the Treasury Market Practices Group ("**TMPG**"), which is sponsored by the New York Federal Reserve Bank.[8] The TMPG's recommendations expressly called for two-way margining, not one-way margining and, further, the TMPG's recommendations expressly indicate that such margining is intended to mitigate counterparty risk for the benefit of *all* market participants, *not just dealers*.[9] The FHLBanks' two recommendations are directly in line with the TMPG's stated purpose and, therefore, in line with FINRA's stated purpose for the Proposed Rule. However, FINRA has refused to adopt these two recommendations and has failed to provide an adequate explanation of why adopting such recommendations is inappropriate at this time. The refusal to include provisions to protect investors in the TBA market, particularly when recommended by a group of market participants sponsored by one of the principal U.S. safety and soundness regulators, is inconsistent with the Exchange Act's stated purpose for RSAs.

b. The Proposed Rule's failure to require two-way margining is not in line with market practice.

As discussed in FHLBanks Letter 3, two-way margining is already the industry standard for certain of the Covered Agency Transactions falling within the scope of the Proposed Rule. This is reflected in the form of Master Securities Forward Transfer Agreement developed by the Securities Industry and Financial Markets Association ("**SIFMA**").[10] The rationale for requiring two-way margining is that *both* parties to an agency mortgage-backed securities transaction are exposed to risk owing to market value changes. Requiring only one-way margin would increase systemic risk—contrary to the Proposed Rule's purpose—because non-FINRA members would

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[8] *See* First Amendment Release at page 3533.
[9] *See* pages 5 and 1, respectively, of the TMPG's "Best Practices for Treasury, Agency Debt, and Agency Mortgage-Backed Securities Markets", *available at* https://www.newyorkfed.org/medialibrary/microsites/tmpg/files/TMPG_June%202015_Best%20Practices.
[10] Two-way margining is also a hallmark of the repurchase market. *See, e.g.*, SIFMA's 1996 form of Master Repurchase Agreement, paragraph four of which calls for two-way margining.

be exposed not only to the settlement risk that they have always borne in such transactions, but also to credit risk with respect to the margin they must post to FINRA members. Accordingly, in this regard, the Proposed Rule runs counter to FINRA's mandate to protect the public interest and investors.

c. The Proposed Rule fails to recognize the counterparty credit risk borne by non-FINRA members.

According to the FINRA Trade Reporting and Compliance Engine ("**TRACE**") system, in 2015 twenty-five firms captured 93.8% of the trading in the TBA market. Of these twenty-five firms, the highest credit ratings, afforded by Moody's, S&P and Fitch were Aa3, A+ and AA-, respectively. As a result, in certain instances, a FINRA member's counterparty to a Covered Agency Transaction will be more creditworthy than the FINRA member itself. As an example, the FHLBanks are highly creditworthy GSEs, each of which is individually rated Aaa by Moody's and AA+ by S&P. Thus, in most (if not all), instances, the FHLBanks are more highly rated than their FINRA member counterparties and pose an inherently low credit risk to such FINRA members.

Providing for two-way margining and affording counterparties the right to have the margin they post to a FINRA member segregated will afford heightened protection in the event that a FINRA member defaults with respect to a Covered Agency Transaction. This is particularly important where entities like the FHLBanks face greater exposure than the FINRA member.

d. Two-way margining and segregation of margin have been adopted by other regulators on the basis that they reduce systemic risk.

In other contexts, U.S. federal regulators have determined that two-way margining and collateral segregation are appropriate. Last year, the U.S. Prudential Regulators, *i.e.*, the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Farm Credit Administration, and the Federal Housing Finance Agency, adopted regulations to require two-way margining of swaps and security-based swaps and the segregation of initial margin.[11] The rationale for this is that two-way margining and collateral segregation reduce systemic risk by protecting both parties to a swap or security-based swap from the effects of a counterparty default.[12]

As discussed above, in certain instances, the counterparty to a FINRA member in respect of a Covered Agency Transaction may be more creditworthy than the FINRA member, yet

[11] *See* Margin and Capital Requirements for Covered Swap Entities Agencies, 80 Fed. Reg. 74,840 (Nov. 30, 2015), ("**Swaps Margin Rule**") *available at* https://www.gpo.gov/fdsys/pkg/FR-2015-11-30/pdf/2015-28671.pdf.
[12] *See id.* at 74,866 and 74,873.

FINRA's Proposed Rule does not afford such counterparty the ability to mitigate its credit risk to that FINRA member via two-way margining and the segregation of margin. It is difficult to not view the Proposed Rule as inconsistent with the protection of the public interest and investors where the Prudential Regulators, albeit with respect to different instruments, have taken the view that two-way margining and margin segregation for swaps and security-based swaps reduce systemic risk.

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We appreciate the opportunity to comment. Please contact Jamie Cain at [redacted] or [redacted], or Ray Ramirez at [redacted] or [redacted], with any questions you might have.

Respectfully submitted,

James M. Cain
Partner

cc: FHLBank Presidents
FHLBank General Counsel