O L S H A N

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June 15, 2021

By Electronic Mail (rule-comments@sec.gov)

Vanessa Countryman, Esq.
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Re: SR-FINRA-2021-010: Notice of Filing of a Proposed Rule Change to Amend the Requirements for Covered Agency Transactions Under FINRA Rule 4210 (Margin Requirements) as Approved Pursuant to SR-FINRA-2015-036

Dear Ms. Countryman:

Thank you for this opportunity to provide comments on the proposed amendments to FINRA Rule 4210 (the "Proposed Amendments") published on May 19, 2021, which would establish margin requirements for Covered Agency Transactions (defined below) on behalf of Brean Capital, LLC ("Brean").[1] Brean has considerable experience in the mortgage-backed security ("MBS") markets and, in particular, with Covered Agency Transactions that are the Proposed Amendments' subject. We would appreciate the opportunity to schedule a meeting to discuss our serious concerns, which are described below.

We have raised our concerns regarding the basis, operation and market impact of the proposed amendments with the Staff and FINRA since 2014, when FINRA first contemplated the unprecedented action of imposing margin requirements on Covered Agency Transactions. Until then, broker-dealer risk had been successfully addressed through net capital requirements. As we wrote in our prior comment letters, the imposition of mandatory margin requirements would have a negative effect on market liquidity, particularly on the liquidity that firms like Brean provide to the regional dealers,

[1] Notice of Filing of a Proposed Rule Change To Amend the Requirements for Covered Agency Transactions Under FINRA Rule 4210 (Margin Requirements) as Approved Pursuant to SR-FINRA-2015-036, Exchange Act Release No. 91937 (May 19, 2021), 86 Fed. Reg. 28161 (May 25, 2021) (hereinafter "Notice"). We understand that Proposed Amendments would supersede SR-FINRA-2015-36, as approved on June 15, 2016, and amended thereafter.

banks, mortgage originators and other institutional investors that are important participants in the Agency MBS market. In particular, SR-FINRA-2015-036 as adopted, although not yet implemented, in fact enhances risk in the market and has already had a strong anti-competitive effect, providing primary dealers with disproportionate power to dictate terms in the market and shifting business to regional bank dealers not subject to a margin regime. If implemented, SR-FINRA-2015-036 would diminish the role of regional broker-dealers, such as Brean, in this important space or severely limit the business they can do in the ordinary course, because it would deplete the capital necessary to operate as a broker-dealer. It would be a perverse result if this regulation shifts trading to less regulated markets.

Although we appreciate FINRA's effort to address our concerns and those of other market participants, the Proposed Amendments remain flawed and do not address the harm that they purport to address and instead will cause to a substantial portion of the Agency MBS market. This is because structural flaws make the architecture of the Proposed Amendments unworkable. Margin schemes presuppose a T+2 settlement date. Covered Agency Transactions, however, by design do not settle on T+2 in the normal course of business; instead, most settle on a monthly "good day" schedule established by SIFMA. Moreover, a meaningful portion of the MBS market does not "net" under the Proposed Amendments (non-netting Specified Pools and new issue Collateralized Mortgage Obligations ("CMOs")) because of their unique characteristics.

For firms like Brean, this means that, in the event of market movement, they will be required to post cash margin at a multiple of the regulatory net capital currently required to support the trade. At the same time, firms like Brean in ordinary circumstances cannot collect margin from customers (although this seems to be what FINRA envisions) because (a) the customers are not permitted or will not choose to have margin accounts; and (b) the mechanism does not currently exist that would enable an introducing broker to capture a customer's margin or to advance it to or among counterparties. The

use of their own cash for margin will sharply reduce the liquidity that regional broker-dealers provide to the MBS markets and will likely cause them to exit it or to diminish their activities. These exits in turn will harm regional dealers, banks, mortgage originators and the regional broker-dealers' other customers, because they tend not to have access to, or do business with, the primary dealers.

The core problems created by the Proposed Amendments do not resolve the issues presented by SR-FINRA-2015-036, as currently promulgated. For this reason, the Proposed Amendments should not be approved, and those portions of SR-FINRA-2015-036 that pertain to Covered Agency Transactions should be repealed. Instead, we urge market participants to collaborate with DTCC to enhance its current clearing facility capacity to make all bonds, including non-netting Specified Pool Transactions and new issue CMOs, netable. This will increase market transparency and stability without the threat to liquidity and competition presented by the Proposed Amendments.

I. The Marketplace for Covered Agency Transactions

A. Brean Capital

The business of Brean is representative of other regional broker-dealers active in the Agency MBS market. Brean's MBS & Rates division provides sales, trading, banking and advisory services on a wide range of mortgage and asset-backed securities, U.S. Treasury and government agency securities, structured products such as CLOs and CDOs, whole loans, and other securities. The trading volume of the MBS & Rates division is over $100 billion in securities annually, and Brean holds approximately $1 billion in inventory to facilitate customer liquidity. The MBS & Rates team consists of over 65 professionals, including over 35 sales professionals, who have developed strong relationships with more than 600 institutional investors including mutual funds, pension funds, insurance companies, hedge funds, investment managers, and investment advisors by providing value-added investment ideas and access to execution services and inventory capital. To conduct these activities, Brean maintains substantial excess net capital.

Brean's principals have substantial experience in the Agency MBS market. Brean's CEO, Robert Fine, has been active in these markets since 1991; its Executive Managing Director, Robert Tirschwell, since 1992, and Principal Operations Officer, John Macklin, since 1991.

Brean operates as an introducing broker. Brean, like 80% of its peers in this market, clears through Pershing, Inc. As part of that clearing relationship, Pershing holds substantial collateral. Pershing has the *contractual* right to collect margin from Brean on when-issued securities or new issue CMOs under certain market conditions.

Brean understands that it may be exposed to risk if counterparties, which primarily include broker-dealers, banks and other financial institutions, do not fulfill their obligations. This gives Brean a strong incentive to review the creditworthiness of its counterparties. Accordingly, Brean's policies require it to do so, just as Brean's counterparties review Brean's creditworthiness before doing business with Brean.

B. Market Participants

Most residential mortgages in the United States are securitized, with loans pooled into a separate legal trust, which issues the MBS and passes on mortgage payments to the MBS investors after deducting mortgage servicing fees and other expenses. In the agency market, each MBS carries a credit guarantee from Fannie Mae, Freddie Mac or Ginnie Mae. The market in Agency MBS and the liquidity provided by that market are essential to the stability of the U.S. housing market, because the capital provided by Agency MBS permits the underwriting of new loans.[2]

The MBS market has operated with long settlement dates for more than three decades. During these years, a large liquid market has evolved. In 2020, primary dealers reported on TRACE over $3.4

[2] *See* James Vickery & Joshua Wright, TBA TRADING AND LIQUIDITY IN THE AGENCY MBS MARKET, Federal Reserve Board of New York, Policy Review at 2-3 (May 2013); *see also* James Collin Harkrader & Michael Puglia, FIXED INCOME MARKET STRUCTURE: TREASURIES VS. AGENCY MBS, FEDS Notes (Aug. 25, 2020), (https://www.federalreserve.gov/econres/notes/feds-notes/fixed-income-market-structure-treasuries-vs-agency-mbs-20200825.htm).

trillion of volume in Agency MBS, approximately $308 billion of volume for Specified Pool transactions and $22 billion for CMOs. The comparable volume in 2020 for TBA securities is approximately $3.2 trillion.[3] The MBS market serves a critical market function by allowing mortgage lenders to hedge the risk that market interest rates may change and/or fund their origination pipelines. The market also creates efficiencies and cost savings for lenders that are passed on to borrowers in the form of lower rates.

The market is characterized by more than 100 broker-dealers of varying sizes, who often buy and sell on a riskless basis or effectuate an offsetting trade within hours. There are approximately 20 primary dealers that operate in market-making and principal roles. Most primary dealers are major financial institutions and have bank affiliates. Studies by Federal Reserve Board ("FRB") economists have shown that the top 10 primary dealers intermediate the vast majority of Agency MBS transactions.[4]

Consistent with the market's desire to limit risk, the vast majority of broker-dealers in the Agency MBS market are introducing brokers, trading through clearing firms. Many of the introducing firms are regional or smaller broker-dealers, and include minority, woman and veteran-owned firms. These broker-dealers play an important role in the secondary market, typically serving the role of liquidity provider by matching buyers and sellers of secondary, less liquid non-netting Specified Pools and new issue CMOs, currently using limited balance sheets in the process. The clearing firms hold substantial collateral of introducing brokers such as Brean and, as noted, a single clearing firm, Pershing, clears for the majority of the introducing brokers. Some of the regional broker dealers have bank affiliates, which provides the ready ability to avoid the Proposed Amendments.

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[3] FINRA publishes TRACE data at https://www.sifma.org/resources/research/us-mortgage-backed-securities-statistics/.

[4] Harkrader & Puglia, *supra* note 2, at 4. Data collected from April 1, 2019 to December 31, 2019 indicated that the top 10 dealers intermediated 87% of Agency MBS trades through DTC. *Id.*

Investors in Agency MBS are a wide range of institutions, such as state and local pension plans, investment companies, investment funds, insurance companies, regional banks and mortgage originators. Many of these institutions trade primarily through introducing brokers, in large part because firms like Brean are best-suited to fill their needs. As a result the introducing brokers know their clients and client's risk profiles well, and vice-versa. The FRB is also a significant participant in the market.

C. Types of Covered Agency Transactions

The Rule Amendment defines Covered Agency Transactions as To-Be-Announced (TBA) transactions, Specified Pool Transactions, and Transactions in Collateralized Mortgage Obligations, or CMOs.

The TBA market, which was established in the 1970s, is by far (90%) the largest segment of the Covered Agency Transactions market. TBAs facilitate the forward trading of MBS issued by Fannie Mae and Freddie Mac, as well as Small Business Administration (SBA) backed Asset-Backed Securities (ABS). With TBAs, 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 is not specified at the time of execution.

The TBA market generally adheres to "Good Delivery Guidelines," which are set forth in the Uniform Practices Manual maintained by SIFMA, in consultation with SIFMA members, and utilizes standardized trade documents developed by SIFMA. The Good Delivery Guidelines functionally standardize the market.[5] TBAs have one good delivery and one settlement date per month (the "Good Day", depending on pool type), with specific pool information provided two days before settlement date.

[5] *See* TBA MARKET FACT SHEET, SIFMA (2015) (https://www.sifma.org/wp-content/uploads/2011/03/SIFMA-TBA-Fact-Sheet.pdf).

Critical to understanding the impact of the Proposed Amendments, most TBA trades are netable, and therefore will not result in a margin charge or increased net capital charge to regional broker-dealers. It is trading in non-netting Specified Pool Transactions and new issue CMOs that will be most adversely affected by the Proposed Amendments, because such trades, even in riskless transactions, will not net, because of their unique nature, under the Proposed Amendments.[6] Thus, while today, such trades may result in a 10% charge to net capital based on the mark to market loss, under the Proposed Amendments, the same trades may result in both a net capital charge at 100% of the mark to market loss *and* a requirement to collect the same amount of margin.

Specified Pool Transactions are transactions in Agency MBS or SBA ABS requiring the delivery at settlement of a pool or pools that are identified by a unique pool identification number at the time of execution. The actual identities of bonds to be bought and sold are known at the time of the trade. Certain Specified Pools are deliverable into a TBA short, and will net for the purposes of the Proposed Amendments. But many Specified Pools will not net under the Proposed Amendments. These non-netting Specified Pools generally do not meet the "Good Delivery Guidelines" to be a TBA, in that the pools could be backed by high-balance mortgages, 40-year mortgages and adjustable-rate and interest-only mortgages. Non-netting Specified Pools may be higher value than TBAs, in that they have the most advantageous prepayment characteristics, but lack the liquidity of the TBA market because they are not fungible.[7]

New issue CMOs subject to the Proposed Amendments (i.e., not those CMOs that trade in secondary markets) are a type of securitized product backed by Agency pass-through MBS, mortgage loans, other types of MBS or assets derivative of MBS, that are structured in multiple classes of

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[6] *See* Notice, Exhibit 5 at proposed 4210(e)(2)(H)(a).
[7] *See* James Vickery & Joshua Wright, TBA TRADING AND LIQUIDITY IN THE AGENCY MBS MARKET, Federal Reserve Board of New York, Staff Report No. 468 at 6-7 (Aug. 2010) (https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr468.pdf).

tranches with each class or tranche entitled to receive distributions of principal or interest according to the requirements adopted for the specific class or tranche.

Each non-netting Specified Pool and new issue CMO is unique, and, therefore, substitute securities may be impossible to locate. Like TBAs, non-netting Specified Pool generally settle on a scheduled "good day," which is the same scheduled date as TBAs. New issue CMO transactions generally settle on the last business day of the month.

D. Operation of the Market for Covered Agency Transactions

TBA trading occurs electronically on an over-the-counter basis, primarily through two platforms, DealerWeb (for inter-dealer trades) and TradeWeb (for customer trades). Quotes on DealerWeb are "live," in the sense that dealers must trade at their posted prices if a counterparty wishes to do so. TradeWeb continuously provides indicative bids and offers (known as Composite Market indicators) for each MBS coupon, offering investors real-time estimates of the prices at which trades can be executed. Although these quotes are indicative, internal Federal Reserve Bank analysis shows that the quotes generally track prices of completed transactions closely.[8]

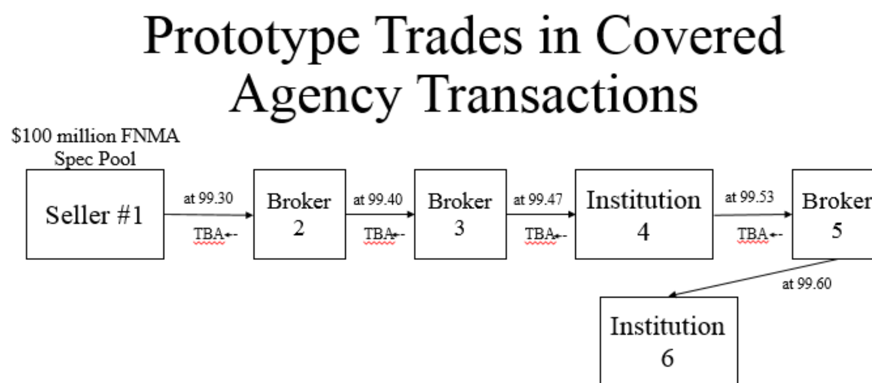
Since May 2011, market participants that are members of FINRA have been required to report Agency MBS trades to the TRACE (Trade Reporting and Compliance Engine) system. After the close of each trading day, FINRA publicly reports summary statistics of daily trading volumes and prices, such as the weighted average transaction price for different coupons, issuers, and settlement months, as well as the number and volume of trades. Due to the existence of multiple data sources (for example, Bloomberg), market participants obtain timely estimates of current market prices for TBA contracts.

A single specified pool may be split or may have multiple buyers who then sell the securities in a chain of transactions, all closing on the "good settlement" date. In addition, broker-dealers, as well as originators, typically buy (or sell) a TBA security as a hedge against their trading of a non-

[8] Vickery & Wright, *supra* note 2, at 9.

netting Specified Pool or new issue CMO. The premise of SR-FINRA-2015-036, as currently promulgated, and the Proposed Amendments is that broker-dealers are subject to credit risk as the value of the MBS security fluctuates between trade date and settlement date.[9] In reality, their exposure is limited by hedging and offsetting trades, designed to lock in a modest profit (or loss) depending on the market's movement. This creates a "daisy chain" of sales for these securities, offset with TBAs, illustrated by Figure A. The intermediary parties in the chain reduce their exposure with corresponding buys and sells. A chain of sales could well exceed the length in this example. These chains develop over time, with downstream buyers purchasing closer to the settlement date.

Figure A



Even in the most volatile months of 2008, the market for Agency MBS securities operated properly. While trading in non-agency MBS became illiquid, economists at the N.Y. Federal Reserve observed, "In contrast, issuance and trading volumes in the agency MBS market remained relatively robust throughout the crisis period."[10] The role of clearing brokers, the use of hedging, and the

[9] Notice at 4 and n.9.
[10] Vickery & Wright, *supra* note 2, at 3.

collateral maintained by broker-dealers all assured the ability of parties to honor their commitments on settlement date.[11]

With the onset of COVID-19, the Agency MBS market again faced a severe disruption. The issue, however, was unrelated to the "risk" sought to be addressed by SR-FINRA-2015-036 and the Proposed Amendments. Instead, as economists (Chen *et al.*) at the N.Y. Federal Reserve who studied the data observed, the disruption was that the primary dealers reduced their activity (in part to protect their balance sheets), leading to a sharp reduction in liquidity in the market.[12] The FRB stepped in and provided liquidity to the primary dealers through purchases and hedging activity.[13] By contrast, it was Brean's experience that regional broker-dealers provided robust liquidity in terms of balance sheet and sales efforts.

A key takeaway of Chen *et al.* is that the liquidity provided by broker-dealers is critical to the Agency MBS market, which in turn provides crucial liquidity to the housing market.[14] However, the Proposed Amendments, as shown below, severely restrict the liquidity of introducing brokers whose role is key to the smooth operation of the Agency MBS market. In short, they solve for a problem that does not exist, but would increase the likelihood – by removing these broker-dealers from the market – that the next contraction in the Agency MBS market will be less manageable and concentrate further risk in the hands of banks.

II. The Proposed Amendments Will Diminish and Impair the Market for Covered Agency Transactions

A. The Proposed Amendments Enhance Systemic Risk

The Proposed Amendments do not reflect the realities of the market for Covered Agency Transactions. It is telling that the Notice's discussion of "Anticipated Costs" speaks in general terms

[11] *Id.*
[12] *See* Jiakai Chen *et al.*, DEALERS AND THE DEALER OF LAST RESORT: EVIDENCE FROM MBS MARKETS IN THE COVID-19 CRISIS, Federal Reserve Board of New York, Staff Report No. 933 at 6 (Jul. 2020, rev. May 2021).
[13] *Id.*
[14] *Id.* at 4, 6.

true of any trade regulation, *i.e.,* "The magnitude of these costs depends on the firm's trading activity," rather than evincing any consideration of real-world trading.[15]

The Proposed Amendments enhance systemic risk in at least five ways: 1) they remove liquidity from the Agency MBS markets; 2) they introduce substantial uncertainty due to the difference between trade prices and the calculation of mark to market loss for margin purposes; 3) they do not address the "daisy chain" fail problem; 4) they increase the bargaining power of primary dealers to detriment of introducing brokers; 5) they encourage those broker-dealers with bank affiliates to the shift the business to banks, which will not be subject to Proposed Amendments and – in the absence of this onerous regulation – will have a far lower cost of capital.

The operation of the Proposed Amendments would in fact have a heavy and disproportionate financial and regulatory impact on regional broker-dealers, increasing the costs of riskless transactions at least ten-fold. This use of capital will drastically reduce the liquidity that regional broker-dealers bring to the market. The costs would also fall heavily the regional banks and mortgage originators that rely on firms like Brean to hedge their risks. In Brean's experience, primary dealers are ill-fitted to provide these types of institutions with the service they need because of the customers' size or to understand those customers' business and credit needs.

The Proposed Amendments do not address the many uncertainties that exacerbate risk previously identified in Brean's comment on SR-FINRA-2015-036. Although FINRA proposes to delete the current definition of "mark to market loss", the Proposed Amendments still do not identify the party responsible for marking-to-market the MBS or the methodology for doing so.[16] As a result, the parties are left to negotiate over these items. But parties setting prices have conflicting interests as buyer and seller and will likely have different views on value in setting margin. For non-netting

[15] Notice at 29.
[16] Notice at 11-12, n.26.

Specified Pools and new issue CMOs, there is no definitive price established by a reliable market, as these securities may be unique or hard to locate. For this very reason, many of these securities do not clear on FICC, Fixed Income Clearing Corporation. As a result of their unique nature, there is a significant risk that marks on non-netting Specified Pools and new issue CMOs that vary from actual value, imposing collateral obligations where none should exist. This risk is multiplied, as margin departments often set value, independent of a trading desk. To do so, they rely on models to price unique securities, which may produce incorrect results.

The Proposed Amendments have not addressed the problem presented by the "daisy chain" that is the reality of many Covered Agency Transactions. A key feature in the Proposed Amendments remains the requirement that a position be terminated, *i.e.* sold out, if a party fails to post collateral within five days.[17] As discussed above (and shown in Figure A), Covered Agency Transactions are generally traded through a chain of buyers and sellers, with modest markups. The vast majority of brokers are hedged, with minimal exposure and many brokers may have even executed "riskless trades," i.e., placing the "buy" order only when a "sale" order was in hand. On a forced liquidation, however, downstream parties will not be able to locate a substitute security for non-netting Specified Pool and new issue CMO transactions. A non-delivery by one party places all other parties in default, leaving them to sort out who owes what to whom on a difficult-to-price security that has not been delivered through no fault of any downstream party. The costs and risks associated with this process will only deter trading—or lead to higher prices by adding a liquidity premium, harming the consumers. This adds a new, untenable element to each party's risk analysis. Before the Rule, one could look to the counterparty's financial strength; now, under SR-FINRA-2015-036 and the Proposed Amendments, *one must consider each trading party with whom the counterparty does business at the time of the trade,* since a failure to meet margin at any point in the chain can lead to a failed settlement

[17] Notice at 13-14; *see* new paragraph (e)(2)(H)(ii)d.3 in Exhibit 5 to the Notice.

further down in the chain. As an example, Brean has been asked by one counterparty to disclose all of its offsetting positions, so that counterparty could assess the possible consequences of a default by someone else dealing with Brean.

The daisy chain presents numerous practical problems that have not received consideration in the Notice. For example, there is no real way to foreclose on collateral. Parties in the daisy chain have no securities to liquidate, as would be the norm in margin arrangements. In addition, multiple parties in the chain could be required to put up margin on the same security, a redundancy that further removes liquidity from the market.

Nor does the Notice address the role of the clearing broker or reflect that FINRA has considered the actual way in which introducing brokers clear trades. As noted, Pershing, the dominant clearing firm, already imposes by contract margin requirements. The Notice does not reference any data that would support that the collateral currently collected by Pershing is not sufficient to protect against the risk the Proposed Amendments seek to address.

The Proposed Amendments have also not considered the reality of the many institutional customers unwilling or unable to enter into margin agreements[18] or the inability of many regional broker-dealers to collect margin even if a customer posts it with a clearing firm. Since FINRA announced inclusion of Covered Agency Transactions in Rule 4210, many counterparties have required used of the standard form Master Securities Forward Transaction Agreement ("MSFTA") developed by SIFMA. Brean and other regional broker-dealers had not previously executed these agreements. MSFTAs are not, however, a substitute for a margin agreement and do not require the posting of collateral. In 2018, SIFMA issued a proposed Form of MSFTA that includes Covered Agency Transactions in its scope in anticipation of SR-FINRA-2015-036 taking effect. The proposed

[18] Certain institutional investors, such as state pension funds, may be prohibited by their charters from pledging of pension assets, and therefore cannot post margin. Similarly, registered investment companies cannot re-pledge collateral.

MSFTA form provides that a broker may close out *all* positions based on a default in *one* position.[19] Any such across-the-board liquidation would not only cause multiple breakdowns in otherwise financially sound chains of distribution, but also threaten the broker with insolvency. This points to another systemic risk factor, an increase in insolvency risk. If a party becomes insolvent, those who have posted collateral with the insolvent party stand to lose their collateral. Thus, one firm's failure is now more likely to impact other firms.

The Proposed Amendments continue to overlook the ample protections already in place to guard against defaults. Clearing brokers already require introducing brokers to post substantial collateral and effectively already require margin for mark to market losses on when-issued MBS (*see* Illustration 3 below). In addition to the collateral at the clearing firm, regional broker dealers that trade MBS typically have substantial net regulatory capital. Disclosure through monthly focus reports, and other financial data, enable market participants to select counterparties that are fiscally solvent. A broker-dealer like Brean, which believes it is typical of regional broker-dealers that trade in non-netting Specified Pools and new issue CMOs, has a strong self-interest in remaining fiscally solvent and is well positioned in the event of any market disruption, as was proven out in March of 2020.

Additional risk is presented because the proposed rule is easily avoided by broker-dealers that have bank affiliates. Such broker-dealers have already shifted trading in Covered Agency Transactions to their bank affiliates and now altogether avoid compliance with the Proposed Amendments, while certain customers have also shifted business to banks, because they are not permitted to post margin or because the do not want to underwrite the credit risk of doing business with a FINRA broker-dealer. This effectively makes banks a reduced-cost alternative, a significant selling point that puts Brean and other FINRA broker-dealers at a severe disadvantage. This migration to a less regulated marketplace

[19] SIFMA Form of Amendment to Conform with FINRA 4210 (Jan. 30, 2018) at ¶8 (https://www.sifma.org/wp-content/uploads/2017/06/2018-MSFTA-Amendment.pdf).

leads to another concern. Trades by non-FINRA member banks and their affiliates are not reported on TRACE, reducing transparency and pricing reliability while introducing greater risk and uncertainly into the markets.

B. Real World Examples Show the Proposed Amendments' Devastating Impact on Regional Broker-Dealers

It is easiest to understand the impact of the Proposed Amendments by considering a typical trade booked for good day settlement between Brean and a primary dealer. In **Illustration 1**, Brean buys \$100 million of a non-netting Specified Pool of Ginnie Maes from a primary dealer, and sells \$100 million of TBAs to a customer to hedge the exposure. This is a typical buy with an off-setting position. After trade date, the market decreases by 3 points. Brean takes a \$3 million mark to market loss on the Specified Pool, which is offset by the mark to market gain on the hedge.

Under current FINRA rules, Brean would take a \$300,000 charge to its regulatory capital for the mark to market loss on the Specified Pool. However, under the Proposed Amendments, broker-dealers will be required to post margin for "each counterparty's excess *net* mark to market loss."[20] As Illustration 1 shows, because the pool is not netable, it will result in a \$3,000,000 margin call under the Proposed Amendments:

[20] Notice at 8, 14 (emphasis added.)

Illustration 1 - Financial and regulatory impact of 4210										
	Current					*Proposed 4210*				
	Cash	Margin @ Clearing Firm	WI Req @ Clearing Firm	Reg Capital	TOTAL	Cash	Margin @ Clearing Firm	WI Req @ Clearing Firm	Reg Capital	TOTAL
MTM	-	-	-	(300,000) *	(300,000)	-	-	-	-	-
Margin Call	-	-	-	-	-	(3,000,000) **	-	-	-	(3,000,000)
TOTAL	-	-	-	(300,000)	**(300,000)**	(3,000,000)	-	-	-	**(3,000,000)**

Transaction Description		
T/D	S/D	
6/1/2021	6/21/2021	Brean Capital ***BUYS*** $100mm of Ginnie Mae II Pool (G2 MA7359 - ***NON NETABLE / NON DELIVERABLE***) for their inventory from a primary dealer
6/1/2021	6/21/2021	Brean Capital ***SELLS*** $100mm of TBA (G2SF 2 1/2 Jun21 - ***NETABLE / DELIVERABLE***) to hedge their exposure to the pool
		**** Brean Capital is facing different counterparties on each of these transactions***

Subsequent Event and Impact to Brean Capital	
Event	- After trade date and before settlement date the value of the pool purchased by Brean decreased by 3 points or $3mm dollars.
Current Impact	- From an equity perspective the mark to market loss of $3mm on the long pool purchased would be offset by a $3mm mark to market gain on the hedge position. * - Brean would incur a $300k regulatory capital charge due to the decrease in market value of the pool purchased (10% x $3,000,000)
Proposed Impact	** - Brean is issued a margin call for $3mm from the seller of the pool due to the fact that the pool is NON NETABLE / NON DELIVERABLE in essence a bilateral transaction & therefore must wire $3mm to the seller of the pool to satisfy the call. Additionally, due to the fact that Brean is not a member of the MBSCC it is unable to recover from the net any of the margin it was required to post. - By satisfying the margin call to the seller of the pool the regulatory capital charge of $300k would be eliminated.
Summary	- Even though Brean Capital has effectively hedged their exposure by selling a TBA of the same size under 4210 rules they would be required to post margin to the seller of the NON NETABLE / NON DELIVERABLE pool. Currently the impact of this transaction to Brean would be a $300k regulatory charge whereas under the proposed rule 4210 they would be required to post $3mm in margin, or an increase of $2.7mm.

Illustration 2 shows what Brean considers a typical riskless trade. In this illustration, Brean buys $100 million of a non-netting Specified Pool of Ginnie Maes from a primary dealer, and sells $100 million of a non-netting Specified Pool of Ginnie Maes to a customer. Again, after trade date, the market decreases by 3 points.

Under current FINRA rules, Brean would take a $300,000 charge to its regulatory capital for the mark to market loss on the Specified Pool it purchased. However, under the Proposed Amendments, Brean will be issued a $3,000,000 margin call by the seller of the pool it purchased and wire cash to that party. Under the Proposed Amendments, Brean is also supposed to collect $3,000,000 in margin from its customer due to the mark to market loss in the customer's Specified Pool. Brean, however, cannot do so because it does not have or cannot have a margin agreement with the customer. Brean must therefore take a $3,000,000 regulatory capital charge:

Illustration 2 - Financial and regulatory impact of 4210										
	Current					*Proposed 4210*				
	Cash	Margin @ Clearing Firm	WI Req @ Clearing Firm	Reg Capital	TOTAL	Cash	Margin @ Clearing Firm	WI Req @ Clearing Firm	Reg Capital	TOTAL
MTM	-	-	-	(300,000) *	(300,000)	-	-	-	-	-
Margin Call	-	-	-	-	-	(3,000,000) **	-	-	(3,000,000) ***	(6,000,000)
TOTAL	-	-	-	(300,000)	**(300,000)**	(3,000,000)	-	-	(3,000,000)	**(6,000,000)**

Transaction Description		
T/D	S/D	
6/1/2021	6/21/2021	Brean Capital ***BUYS*** $100mm of Ginnie Mae II Pool (G2JM 2.5 - ***NON NETABLE / NON DELIVERABLE***) for their inventory from a primary dealer
6/1/2021	6/21/2021	Brean Capital ***SELLS*** $100mm of the same Ginnie Mae II Pool (G2JM 2.5 - ***NON NETABLE / NON DELIVERABLE***) from their inventory to a customer
		**** In principle this is a riskless trade from the Brean perspective.***

Subsequent Event and Impact to Brean Capital	
Event	- After trade date and before settlement date the value of the pool purchased by Brean decreased by 3 points or $3mm dollars.
Current Impact	- From an equity perspective the mark to market loss of $3mm on the pool purchased would be offset by a $3mm mark to market gain on the sale of the same pool. * - Brean would incur a $300k regulatory capital charge due to the decrease in market value of the pool purchased (10% x $3,000,000)
Proposed Impact	** - Brean is issued a margin call for $3mm from the seller of the pool due to the fact that the pool is NON NETABLE / NON DELIVERABLE in essence a bilateral transaction & therefore must wire $3mm to the seller of the pool to satisfy the call. However, Brean is unable to issue a call to the buyer of the same pool due to a variety of reasons and therefore must take the full regulatory capital charge of $3mm. - By satisfying the margin call to the seller of the pool the regulatory capital charge of $300k would be eliminated.
Summary	- Even though Brean Capital has entered into a riskless principle trade under the proposed rule 4210 they would be required to post margin to the seller & take a regulatory capital charge for the amount that they are unable to call from their customer. The impact to Brean currently is a $300k regulatory charge whereas under rule 4210 total impact would be $6.0mm or an increase of 1900%.

Of note, in this example, it does not help Brean under the Proposed Amendments if the customer posts $3,000,000 margin with the clearing broker. That is because it is not clear if Brean has the contractual right to collect the margin and there does not appear to be a mechanism in place today for Brean to collect it.

Illustration 3 shows another normal trade and illustrates the impact on the broker's liquidity when it makes three trades: a sale of $100 million of a netting Ginnie Mae pool to a primary dealer, a purchase of $100 of new issue CMOs from the primary dealer made up of the same Ginnie Mae pool and a sale of the new issue CMO to its customer. Again, after trade date, the market decreases by 3 points before settlement date.

Under current FINRA rules, Brean would take a $300,000 charge to its regulatory capital for the mark to market loss on the new issue CMO it purchased and incur a 1½% charge to its clearing

firm (against the collateral held by the clearing firm) under the contractual margin arrangement applicable to when-issued securities. Under the Proposed Amendments, in addition to the 1½% charge to its clearing firm, Brean would take a $3,000,000 charge to net capital and, because the customer cannot legally margin, must post $3,000,000 to the primary dealer on behalf of the customer as a result of the CMO falling three points on price.

Illustration 3 - Financial and regulatory impact of 4210										
	Current					*Proposed 4210*				
	Cash	Margin @ Clearing Firm	WI Req @ Clearing Firm	Reg Capital	TOTAL	Cash	Margin @ Clearing Firm	WI Req @ Clearing Firm	Reg Capital	TOTAL
MTM	-	-	(1,500,000) ****	(300,000) *	(1,800,000)	-	(1,500,000)	-	-	(1,500,000)
Margin Call	-	-	-	-	-	(3,000,000) **	-	-	(3,000,000) ***	(6,000,000)
TOTAL	-	-	(1,500,000)	(300,000)	**(1,800,000)**	(3,000,000)	(1,500,000)	-	(3,000,000)	**(7,500,000)**

Transaction Description		
T/D	**S/D**	
6/1/2021	6/21/2021	Brean Capital ***SELLS*** $100mm of Ginnie Mae II Pool (G2 MA7311 - **NETABLE / DELIVERABLE**) to a primary dealer from Inventory
6/1/2021	6/30/2021	Brean Capital ***BUYS*** $100mm of New Issue CMO from the primary dealer which was created from the collateral sold, Ginnie Mae II Pool (G2 MA 7311)
6/1/2021	6/30/2021	Brean Capital ***SELLS*** $100m of the same New Issue CMO (Collateral sold to the primary dealer) to Institutional a/c that cannot or will not post collateral to Brean
		**** The trades above are in agreement with the SIFMA settlement schedule (good day settlement)***
		***** As a result the agency pools sold to the primary dealer are netted in FICC and FICC credits the Clearing Firm not Brean Capital, in this example $3mm***

Subsequent Event and Impact to Brean Capital		
Event		**- After trade date and before settlement date the value of the CMO purchased from the primary dealer decreased by 3 points or $3mm dollars.**
Current Impact	*	**- Brean would incur a $300k regulatory capital charge due to the decrease in market value of the CMO purchased (10% x $3,000,000)**
	****	**- Brean is required to post margin to the Clearing Firm in the amount of 1.5% of future settling when issued securities (notional) 1.5% x $100mm.**
Proposed Impact	**	**- Brean is issued a margin call for $3mm from the seller of the CMO to cover the decrease in value so Brean has to wire $3mm in cash to satisfy the call as it cannot use the corresponding decrease in the value of the collateral sold to offset the call because Brean does not have access to the net.**
	***	**Given the fact that Brean is unable to collect margin from the buyer of the CMO it is required to take a regulatory capital charge for the full amount of the call, in this case $3mm. Additionally, since Brean does not have access to the net it must use it's own cash to satisfy the call.**
	****	**- Brean is still required to post margin to Pershing in the amount of 1.5% of when issued securities (notional) 1.5% x $100mm.**
		- By satisfying the margin call to the seller of the CMO the regulatory capital charge of $300k would be eliminated.
Summary		**- SIFMA requires that all CMO securitizations be created in accordance with their settlement calendar known as "good day settlement." In this example Brean would be required to post margin to the seller & take a regulatory capital charge for the amount that they are unable to call from their customer. Under current rules the impact to Brean would be $1.8mm whereas under 4210 total impact would be $7.5mm.**

The illustrations look at trades in isolation. In the real world, dealers do not handle one trade per month; they service multiple customers. This of course magnifies the potential of the Proposed Amendments to use a substantial portion of FINRA broker-dealers' available capital and to restrict their other business activities.

III. The Proposed Amendments Are Anti-Competitive

The Proposed Rule's margin requirements are by their nature anti-competitive, 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. Congress also 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."[21] The Commission must "balance, against other regulatory criteria and considerations, the competitive implications of self-regulatory [actions]."[22]

Although the Notice describes how FINRA has considered the concerns voiced by smaller and medium-sized broker dealers and attempted to fashion the Proposed Amendments with these concerns in mind,[23] it continues to disproportionately burden them and favor broker dealers with 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.[24] But, as 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. Banks also have a lower cost of capital. 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 businesses accordingly.[25]

The Proposed Amendments continue to disproportionately burden small-to-medium sized brokers by imposing a variety of costs that, as compared to those of larger players, are outsized relative

[21] 15 U.S.C. § 78o(a)(2); *see also* 15 U.S.C. § 78w(a)(2).
[22] S. Rep. 94-75, at 13, *reprinted in* 1975 U.S.C.C.A.N. 179, 191.
[23] *See, e.g.,* Notice at 5-6.
[24] *See* Exhibit 5 to Notice, new paragraph (e)(2)(H)(ii)d.3.
[25] FINRA claims that it meets the statutory requirements because, "The proposed rule change, by alleviating this disadvantage, would help promote competition by leveling the playing field among participants in the Covered Agency Transaction market, thereby reducing disruption in the Covered Agency Transaction market without the loss of investor protection." Notice at 23. FINRA offers no data, transaction analysis or other factual support for this conclusion. As Illustrations 1-3 show, the Proposed Amendments will immediately have a material impact on regional broker dealers' balance sheets.

to these brokers' revenues and exceed the 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. As Illustrations 1-3 show, even on a riskless transfer, introducing brokers, to stay in business, face a new reality in which they incur charges to regulatory capital at ten-times the current rate *and* up to twenty-times an impact on balance sheet. These costs pile an additional, unnecessary capital burden—and the cost of that capital—onto these introducing brokers, disregarding the "riskless" nature of their trading position and could expand multi-fold if there is a failure in the daisy chain. None of this capital can be used to provide market liquidity.

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 Specified Pools and new issue CMOs. The Rule thus adds a new element of instability.

Small-to-medium sized brokers will also face burdensome operational costs. It will not make economic sense for dealers that engage in only a moderate amount of Covered Agency Transactions to build the compliance systems, hire new personnel, and implement the margining system required by the Proposed Amendments. 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 Proposed Amendments, 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, especially in times of strife, fulfills its duty to adopt rules that justly and equitably impact market participants.

Although FINRA has delayed the implementation of SR-FINRA-2015-036, there has already been a worsening of the competitive arena between smaller and medium-sized broker dealers forced to enter into MSFTAs for bilateral margining with market-dominant Broker-Dealers and primary dealers. Trading with these major Broker-Dealers is essential to market participation, and these major players can and do use their dominance to impose onerous terms on the smaller and medium-sized broker in such bilateral agreements.

Besides adding costs, and reducing liquidity when an agreement cannot be reached, the MSFTA offers the larger firms this opportunity to exercise market power in other ways. The larger firms insist that each has the exclusive right to value securities and demand collateral under the Rule. Dominant market players may also require more collateral, independent of margin. For example, a major asset manager will not sign an MSFTA with Brean unless it receives 2% of principal as collateral and a unilateral right to price for margin purposes. If Brean buys from a primary dealer and sells to the above asset manager on a riskless basis, Brean could be quadruple margined on a riskless trade. While the Notice acknowledge the burdens faced by smaller firms, the Proposed Amendments do nothing to alleviate them.

IV. The Commission Lacks Authority to Approve the Proposed Amendments

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

The Proposed Amendments are an unauthorized and unreasonable exercise of the Commission's power to regulate margin on Covered Agency Transactions. The text of Section 7 of the Securities Exchange Act of 1934 ("1934 Act") succinctly identifies the FRB, and only the FRB, as responsible for regulating margin.[26] The legislative history of Section 7 likewise indicates that Congress never intended the Commission to administer margin regimes.[27] When Congress passed the

[26] 15 U.S.C. § 78g(a).
[27] *See* H.R. REP. NO. 73-1383, at 7 (1934) (delegating control of credit to the FRB).

Exchange Act, it acknowledged the FRB's "unique and outstanding expertise" in regulating credit.[28] 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."[29]

Section 3(a)(12) of the 1934 defines Covered Agency Transactions as "exempted securities."[30] Significantly, Congress did not grant the FRB or the Commission authority to regulate "exempted securities."[31] Indeed, Section 7 regulates "the amount of credit that may be initially extended and subsequently maintained on any security (other than an exempted security …)."[32]

B. The Proposed Amendments Are an Unreasonable Construction of Section 7

Since it first proposed including Covered Agency Transactions in Rule 4210, FINRA has not provided adequate support to departure from the decades-old regulatory regime wherein Agency MBS have not been subject to Section 7's margin requirements. "A statutory interpretation ... that results from an unexplained departure from prior [agency] policy and practice is not a reasonable one."[33] FINRA's justification that "potential risk arising from unsecured credit exposers that exist in the Covered Agency Transaction market" . . . "could lead to financial losses by dealers" remains insufficient and does not justify the extreme increase in cost of doing business that the Proposed Amendments will cause.[34] The perceived need for "more comprehensive regulation" does not entitle the Commission to reinterpret the text of the Exchange Act.[35]

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[28] *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. NO. 98-994, at 47-48 (1984) (stating that the FRB "has primary rulemaking authority" with respect to margin, while the "Commission and the securities self-regulatory organizations enforce [the FRB's] rules").
[29] H.R. REP. NO. 73-1383 at 7 (1934).
[30] *See* 15 U.S.C. §§ 78c(a)(12) ("[E]xempted securities" include "government securities" . . . .) (internal quotation marks omitted); *id.* at § 78c(a)(42). FINRA Rule 4210(a)(6) adopts the same definition. *See* Self-Regulatory Organizations, Sec. Exch. Act Release No. 78081, at 3-4 (June 15, 2016) ("SEA 34-78081").
[31] *See* 15 U.S.C. § 78g.
[32] *Id.* (emphasis added).
[33] *See Northpoint Tech., Ltd. v. FCC*, 412 F.3d 145, 156 (D.C. Cir. 2005).
[34] Notice at 4.
[35] *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.").

There is no basis to 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 provisions of a statute.[36] The Supreme Court has rejected "forced and unconventional" attempts to imbue a phrase used more than once in the same statute, with different meanings.[37]

Here, the Proposed Amendments contravene this basic principle of statutory construction and Supreme Court precedent. The Exchange Act defines "exempted securities" to include Covered Agency Transactions in Sections 3(a) (12) and 7.[38] Rule 4210(a)(6) defines "exempted securities" the same way, adopting the meaning in § 3(a)(12) of the Exchange Act.[39] But notwithstanding the Rule's definition of "exempted securities" to conform to Section 3(a)(12), the Proposed Amendments seeks to regulate Covered Agency Transactions —which, per their definition—are prohibited from regulation under Section 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.

V. Two Solutions to Address Risk

As shown above, the Proposed Amendments and SR-FINRA-2015-36, if implemented, will create systemic risk and be anti-competitive due to inherent structural flaws in FINRA's architecture. Simply stated, the markets in Agency MBS were not designed to fit into a T+2 structure, a fact recognized by Congress in enacting Section 7 of the Exchange Act.

Brean believes the best approach to address the staff's concerns regarding the markets in Agency MBS, inclusive of non-netting Specified Pools and new issue CMOs, would be for industry participants to enhance the current central clearing facility managed by the Mortgage-Backed

[36] *Est. of Cowart v. Nicklos Drilling Co*., 505 U.S. 469, 479 (1992).
[37] *Id*. at 478-79; *Goldstein*, 451 F.3d at 882.
[38] 15 U.S.C. §§ 78c(a)(12), 78g.
[39] *Id.*; *see* SEA 34-78081, at 3-4.

Securities Division (MBSD) of DTCC. MBSD already provides of automated post-trade comparison, netting, electronic pool notification, pool comparison, pool netting and pool settlement services to the MBS market.

A central clearing facility would solve the issue that non-netable trades present in what would otherwise be riskless trades under the current regulatory structure. Netting would reduce overall collateral requirements to an amount that would be appropriate to the aggregate level of risk for an institution. It would also level the playing field between broker-dealers, who would be subject to the amended Rule 4210, and banks, which are not and diminish the bargaining disparity between primary dealers and the smaller and regional broker dealers.

The claimed barrier to centralized clearing – which has been achieved for most TBAs, but that does not allow a TBA to net against a non-netting Specified Pool – has been the unique nature of each particular Specified Pool or new issue CMO. While a challenge, this should not be a barrier to developing a clearing facility. Trading already occurs electronically on an over-the-counter basis, and all Agency MBS trades are reported on Trace. Moreover, while there might be a modest cost to enhancing the current trading facility, that cost would be insignificant to the cost of capital that would be imposed by the Proposed Amendments.

While Brean firmly believes that the best approach to regulate the market in Agency MBS is not via the ill-fitting margin rules, to the extent that margin is imposed, FINRA should reconsider its approach mindful of the calendar on which Specified Pools and new issue CMOs settle. As discussed, SIFMA sets a "good day" settlement schedule for pools, which provides an industry standard settlement date. The Proposed Amendments would superimpose a margin regime designed around T+2 that is poorly suited for trades that do not settle on T+2. The Proposed Amendments also ignore that most Agency MBS trades are riskless, although this was acknowledged by FINRA's treatment under the net capital rules prior to SR-FINRA-2015-036. As a result, the Proposed Amendments, if

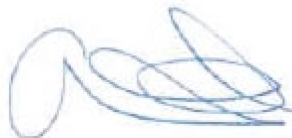
adopted, will make broker-dealers less stable and, therefore, undermine the credibility that regional broker-dealers bring to the marketplace.

A more sound approach would take into account the “good day” settlement schedule. Instead of requiring margin to be collected promptly upon a mark to market loss, for interdealer trades, any rule should not require posting of margin until the next two SIFMA good day settlements (example, an interdealer trade with a 90-day settlement would post collateral; a trade with a 45-day settlement would not). In addition, capital charges should apply at 10% to mark to market loss, as it is calculated today, instead of at 100% to mark to market loss as provide in (e)(ii)(H)d of the Proposed Rule.

VI. Conclusion

The core problems created by the Proposed Amendments do not resolve the issues presented by SR-FINRA-2015-036, as currently promulgated. They create too much risk for regional and smaller broker dealers who play an important role in serving middle-market customers and providing liquidity to the markets. For this reason, the Proposed Amendments cannot be approved, and those portions of SR-FINRA-2015-036 that pertain to Covered Agency Transactions must be repealed. Instead, we urge market participants to collaborate with DTCC to enhance a clearing facility to make all bonds, including non-netting Specified Pool Transactions and new issue CMOs, netable. Alternatively, the Proposed Amendments should be revised consistent with the “good day” settlement schedule for all Specified Pools and the next possible settlement date for new-issue CMOs that applies to the Agency MBS market.

Respectfully submitted,



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FINRA