BDA Bond Dealers of America

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Ms. Vanessa Countryman, Secretary
Securities and Exchange Commission
100 F Street NE
Washington DC 20549

Transmitted by email

In regard to File Number SR-FINRA-2021-010

Dear Ms. Countryman,

The Bond Dealers of America is pleased to provide comments on FINRA's proposed changes to FINRA Rule 4210, Margin Requirements, embodied in 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)" (the "Proposal"). BDA is the only DC-based organization exclusively representing the interests of securities dealers and banks focused on the US fixed income markets.

BDA remains seriously concerned about the effect of the Proposal on the ability of mid-size and regional broker-dealers to compete in the market for agency mortgage-backed securities. Most regional firms do not have margin agreements or Master Securities Forward Transaction Agreements (MSFTAs) with a majority of their mortgage-backed securities (MBS) customers, and we do not anticipate this changing under the Proposal. That means that in trading with customers, regional and mid-size firms will almost exclusively rely on the Rule's provision for a capital charge in lieu of margin, and capital charges faced by firms could increase by orders of magnitude under the Proposal. It would consume so much of mid-size firms' capital and cash that it would effectively impair dealers' market function.

Agency MBS have a unique issuance process. This funding process is vital to our mortgage lending system and has successfully financed trillions of dollars in mortgages for American homeowners over the last four decades. According to policies of the agencies themselves and market conventions in place for decades, the agency MBS issuance process provides for time measured in weeks to assemble a pool of eligible mortgages and create securities from the cash flows. This allows mortgage lenders time to approve loans and fund and hedge their lending activity. New issue trades generally settle on specific, pre-determined dates approved by the Securities Industry and Financial Markets Association (SIFMA).[1] SIFMA's guidelines for clearing and settling MBS transactions are so universally followed that they practically have the force of regulation.

[1] SIFMA, "MBS Notification and Settlement Dates," www.sifma.org/resources/general/mbs-notification-and-settlement-dates/.

New-issue agency MBS is not a T+2 market. FINRA's margin rules for Covered Agency Transactions should reflect long-established market conventions regarding how agency MBS trade and settle. FINRA should not attempt to impose a T+2 framework on a market where it is inconsistent with market norms. Margin requirements for extended settlement transactions should apply when settlement dates exceed market conventions, not when they exceed an arbitrary 2-day standard. We urge the SEC to reject the Proposal and direct FINRA to revise it substantially such that margin requirements do not apply to Covered Agency Transactions unless a settlement date extends beyond normal conventions.

Excessive capital charges and margin requirements

The issuance process for securities affected by the Covered Agency Transactions (CAT) provisions of the Rule involves a series of steps that can take several weeks to complete, necessitating a specified settlement period for a large portion of issuance and placing a significant portion of issuance within the scope of the Rule. Excessive and superfluous capital charges and margin requirements would result from the Proposal for many mid-size firms.

These charges would stem from the inability of dealers to net certain offsetting positions against each other for purposes of the Rule and the role of third-party clearing firms. The inability to net certain transactions arises from industry guidelines covering the clearance and settlement of agency MBS issuance known as "Good Delivery Guidelines."[2] A typical issuance trade involves exchanging a pool of mortgages for securities backed by those mortgages. Even though those two trades generally offset each other and eliminate risk to the dealer, they cannot be considered as a combined, hedged position for the Purpose of the Rule. We offer several examples of CATs and how they would be affected by Rule 4210 (the "Rule") as amended by the Proposal. These examples reflect typical trading activity associated with issuing agency pass-through securities and collateralized mortgage obligations (CMOs).

Example 1:

"Dealer A" purchases for inventory $100 million of non-nettable Ginnie Mae-eligible mortgage pool from Dealer B for settlement in three weeks. In order to hedge that position, Dealer A also sells $100 million TBA-deliverable Ginnie Mae pass-throughs to Dealer B for settlement on the same day in order to hedge the long position. Assume that after the trades but before settlement, the value of $100 million Ginnie Maes falls by three percent.

Under current rules our dealer would face a $300,000 capital charge under the SEC's Net Capital Rule for the drop in value of their long position (10 percent of their mark-to-market loss). This would be the only consequence of the change in market value. Under the Proposal, however, Dealer A would face a $3 million margin call from Dealer B, the counterparty who sold the $100 million non-nettable pool, reflecting 100 percent of the mark-to-market loss on the position. The $300,000 SEC capital charge would no longer apply. So the "cost" of this trade to the dealer would **increase 1000 percent** from $300,000 of capital charges under current rules to $3 million in margin under the Proposal.

[2] SIFMA, *Uniform Practices Manual: For the Clearance and Settlement of Mortgage-Backed Securities and Other Related Securities*, www.sifma.org/resources/general/tba-market-governance/.

Even though Dealer A has hedged their exposure to the Ginnie Mae pool under the Rule, they would be required to post margin to the seller. This happens because the dealer's long and short positions are not nettable against each other for the purpose of the Rule.

Example 2:

Dealer A purchases $100 million of non-nettable Ginnie Mae-eligible mortgage pool from Dealer B for settlement in three weeks and simultaneously sells the same $100 million of Ginnie Mae pool to Customer A for settlement the same day as the long position. Although not a hedge *per se*, the customer sale serves to make the combined trades riskless to Dealer A. After the trade but before settlement, the market value of Ginnie Mae pools decreases by three percent.

The $300,000 SEC capital charge would still apply under current rules. Under the Proposal Dealer A would face a $3 million margin call from Dealer B for the drop in value of the pool they have bought, the long position, as in Example 1. In addition Dealer A would have to impose a $3 million margin call on Customer A for the drop in value of the pool the customer bought. Because Customer A is a DVP customer with no margin agreement or MSFTA and cannot pay margin, Dealer A must take a capital charge in lieu of margin for the customer's position. So Dealer A now faces a $3 million capital charge associated with covering the customer's mark to market loss and a $3 million margin call from Dealer B. The "cost" to Dealer A of this combined trade has now gone from $300,000 under current rules to $6 million in combined capital charges and margin calls under the Proposal, an **increase of 2000 percent** for a combined trading position that poses no risk to Dealer A. This again happens because Dealer A's positions cannot be netted.

Example 3:

Many mid-size and regional firms are not self clearing. They clear trades through "clearing firms," broker-dealers with a dedicated business of clearing trades for others. Clearing firms themselves are subject to Rule 4210, which means they must perform counterparty risk assessments for, and sometimes have to collect margin from, their dealer customers. Broker-dealers who clear through clearing firms generally have margin agreements with those firms.

Assume Dealer A sells $100 million of non-nettable Ginnie Mae pool to Dealer B for settlement in three weeks. Simultaneously Dealer A buys $100 million of CMOs collateralized by the Ginnie Mae pool from Dealer B for settlement in four weeks and sells those $100 million CMOs to Customer A for settlement the same day as the purchase. This example represents a typical trade pattern for creating and selling Ginnie Mae-backed CMOs. Assume the value of Ginnie Mae pools and CMOs drops by three percent between the trade and settlement dates.

Under current rules, Dealer A would face a $300,000 capital charge under the SEC capital rule. In addition, the clearing firm would impose a 1.5 percent margin charge, or $1.5 million, for the forward-delivery, when-issued CMOs, for a total "cost" of the trade of $1.8 million. Under the Proposal Dealer A would face a $3 million margin call from Dealer B for the drop in value of the securities as in previous examples. Customer A does not have a margin agreement or MSFTA and cannot pay margin, so Dealer A must take a $3 million capital charge in lieu of the customer's margin as in Example 2. The $1.5 million margin charge from the clearing firm would still apply. So Dealer A

would now faces a capital charge of $3 million and margin imposition of $4.5 million, $3 million from Dealer B and $1.5 million from the clearing firm, for a combined "cost" of $7.5 million for this low-risk series of trades, **a more than 700 percent increase** relative to current rules.

These examples point out how the CAT provision of the Proposal when applied to typical, low-risk issuance transactions would result in needlessly excessive capital charges and margin requirements. These costs impose a particular burden on mid-size firms because being mid-size, those firms carry less capital in general, and that capital is often more expensive than for larger dealers. BDA members have reported that the Proposal would severely undercut their ability to participate competitively in the CAT market because transactions would consume so much capital and cash. These outcomes would occur even though agency MBS issuance transactions are safe and routine.

Economic Impact Assessment

The Proposal includes a discussion of the economic costs and benefits of amending Rule 4210. We disagree with FINRA's conclusion that the Proposal will "provide relief to member firms." In fact, the effect of the Rule would be the complete opposite.

The economic analysis includes several assumed benefits of the Proposal. For example, the analysis states "FINRA has learned that allowing firms to take a capital charge in lieu of collecting margin would further benefit them by decreasing operational burdens. These burdens arise from the costs associated with obtaining the required margin agreements from counterparties, and from the competitive advantage large dealers have, stemming from their ability to enter into MSFTAs with trading counterparties." While it is true that bulge bracket firms have more leverage with customers in obtaining MSFTAs, any operational benefits associated with capital charges in lieu of margin are far outweighed by the loss of the use of capital while CATs are unsettled.

The economic analysis also states "FINRA believes that this [capital charge in lieu of margin] provision would result in a transfer of the risk from the customer to the member firm. This would benefit the firm's customers and trading counterparties by reducing their costs and decreasing their risk exposure. As such, this could serve as an additional incentive to establishing trading relationships." Capital charges in lieu of margin are seen by mid-size fixed income firms as a last resort for complying with Rule 4210. The Rule would be completely unworkable for many firms without the capital charge provision. Capital charges for firms active in the CAT market who are unable to collect customer margin will be onerous to the point that some mid-size firms may not be able to remain active in the agency MBS market at all. FINRA's economic analysis states "As firms are not required to commit capital in lieu of margin, FINRA expects that firms will only do so when they believe it appropriately balances benefits and risks." In reality firms will only commit capital in lieu of margin when they are unable to obtain margin agreements or MSFTAs, not as a way to rationally "balance risks and benefits."

The most egregious misstatement in the economic analysis relates to competitiveness issues. The analysis states "Collectively, the proposed rule change is expected to potentially level the playing field both between regional and primary broker-dealer members and between member firms and non-FINRA member regional banks." This is not true. The Proposal would have the opposite effect on competitiveness, widening the gap between mid-size and bulge bracket firms and driving some mid-

size firms out of the CAT business altogether. Banks who are not FINRA members are not required to have margin agreements with customers. Customers will naturally choose to trade with the dealers and banks with the lightest regulatory burdens surrounding margin.

De Minimis Transfer and Gross Open Position exceptions

The Proposal retains the Rule's exception from mark-to-market margin or capital charge for mark-to-market losses less than $250,000. It also retains the exception for gross open positions per DVP customer of $10 million or less. BDA fully supports both these exceptions. Both are vital for mid-size fixed-income dealers. Small customer positions and small loss positions do not represent a serious financial risk to the dealer, and imposing margin or capital requirements on these customers and positions would further erode the ability of dealers to serve their customers effectively.

Implementation

The Proposal states "If the Commission approves the proposed rule change, FINRA will announce the effective date of the proposed rule change in a Regulatory Notice to be published no later than 60 days following Commission approval. The effective date will be no later than 120 days following publication of the Regulatory Notice announcing Commission approval."

The compliance deadline for amendments to the Rule related to CATs is currently set for October 26, 2021. We appreciate that FINRA intends to extend that deadline in a separate action. But 120 days for full implementation after finalization of the Rule is not enough time. Planning for compliance with amendments to the Rule will involve significant investments in operations and technology, and those investments cannot begin in earnest until the Rule is finalized. Moreover, the clearing firms will play a central role in implementing this Proposal, both for their own compliance and that of their dealer customers. From our conversations with clearing firms, they are not ready to implement this Rule and will not be within 120 days of finalization. In order to avoid a compliance disaster, we urge the Commission and FINRA to discuss with the clearing firms their plans and schedule for implementing the Proposal before finalizing the Rule and setting a final compliance deadline. Given the breadth of changes imposed by the Proposal, an implementation period of no less than 18 months is warranted.

Conclusion

Mid-size broker-dealers serve an important and unique role in the fixed income markets. They often serve different customers than large firms and serve those customers in different ways. A healthy and vibrant market requires dealers of all sizes and business models to ensure that all issuers and investors get efficient market access.

We recognize and appreciate that throughout the process of addressing CATs under the Rule, FINRA staff have been accessible and have attempted to accommodate concerns raised by regional and mid-size firms. Unfortunately, however, the Proposal remains in a state where it would impose unique and severe pressures on mid-size fixed income broker-dealers. It would impose excessive and outsized capital and margin requirements that are not commensurate with the risks posed by the trades.

We acknowledge that the CAT provisions of the Rule have been under consideration for several years. The Proposal requires additional revision before it is final so that capital and margin requirements imposed by the bill reflect the risk of the transactions they support and do not force mid-size dealers out of the agency MBS market, which would reduce access to the market and diminish liquidity for many participants.

Sincerely,

Michael Decker
Senior Vice President, Public Policy