June 15, 2021

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

J. Matthew DeLesDernier
Assistant 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 Mr. DeLesDernier:

The Securities Industry and Financial Markets Association ("**SIFMA**")[1] submits this letter to the Securities and Exchange Commission ("**SEC**") in response to the request for comment on 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 (the "**Proposal**").[2]

SIFMA appreciates the opportunity to comment on the Proposal and efforts that FINRA has made to modify aspects of Rule 4210 applicable to "Covered Agency Transactions" (such transactions are referred to herein as "**CATs**" and relevant provisions of Rule 4210 are referred to herein as the "**CAT Margin Rules**"). In particular, SIFMA wishes to acknowledge the substantial efforts FINRA has made to engage with industry participants and to adjust the CAT Margin Rules to address concerns about competitive equality, cost and the impact on the market for mortgage securities. Nevertheless, aspects of the Proposal continue to raise concerns for SIFMA members. As detailed below, these are divided into issues relating to (i) implementation timing; (ii) clarifications and concerns regarding a number of the important definitions in the Proposal; (iii) aspects of the new capital charge provisions; and (iv) interaction of the CAT Margin Rules with Rules 15c3-1 and 15c3-3 under the Securities Exchange Act (the "**Exchange Act**").

There are also a number of larger policy questions that SIFMA urges FINRA to address. Most significantly, these are the treatment under Rule 4210 of transactions involving specified pools and Collateralized Mortgage Obligations ("**CMOs**") and the manner in which the rules apply to transactions

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[1] SIFMA brings together the shared interest of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association. For more information, visit www.sifma.org.

[2] 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).

involving both an introducing firm and a clearing firm. SIFMA strongly urges FINRA to undertake further consideration of these matters, which we believe may require modification of the rules as they apply to these transactions and further clarification of the rules, and the related Exchange Act rules as they apply to clearing relationships.

I. Implementation Timing

In the Proposal, FINRA indicated that, following approval by the SEC, the proposed rule changes would be announced in a Regulatory Notice no later than 60 days later, with an effective date no later than 120 days following the Regulatory Notice. SIFMA believes this time period, of less than six months, is much too short.

When FINRA first proposed the CAT Margin Rules, a similar shortened time period was contemplated.[3] In response to that proposal, SIFMA raised a number of concerns, primarily relating to needs to build operations and technology and to negotiate documentation to satisfy the rule requirements. Those concerns continue to be present.[4] While the rules amendments are more familiar to the market than they were in 2015, the timing issues to actually develop technology and to modify contracts have not changed. Further, many firms are already in the process of addressing major regulatory challenges that must be completed over the coming six months, including (1) "phase five" of the implementation of regulatory initial margin requirements for swaps and security-based swaps (September 2021); (2) registration and regulation of security-based swap dealers (November 2021); and (3) benchmark reform transition matters (with significant market and regulatory deadlines at year-end 2021). Regulated firms need the certainty of final rules to make many of the technology and documentation changes necessary for compliance. It is costly to make changes to technology, operations and legal documentation; doing so before final rules are put in place is a significant cost risk to regulated firms.[5] Once rules are finalized, these aspects take time and resources to develop, test and implement. SIFMA continues to believe that an implementation period of at least 18 months is appropriate for these rules, particularly in light of the other major rule changes above, all of which draw on many of the same technology and documentation resources.

II. General Policy Concerns

While our comments in Sections III-V generally assume that some form of the CAT Margin Rules will be implemented, we also want to note the significant policy issues that continue to be raised by this rulemaking.

A. *Competitive Impact on Smaller FINRA-Member Broker-Dealers*. A number of SIFMA members, particularly mid-size and smaller firms, have continued to indicate that the adoption of these rules will cause them to exit the CAT market or significantly decrease their ability to transact in the market. Customers may be unwilling to post margin to these broker-dealers, particularly as customers may also elect to transact with banks that are not required to collect margin.[6] Many of these firms expect to be lower on the priority list for counterparty margin agreement negotiation than larger-sized firms, given that counterparties may prioritize their largest trading relationships first, or may simply limit the number of negotiations or collateral

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[3] Notice of Filing of a Proposed Rule Change To Amend FINRA Rule 4210 (Margin Requirements) To Establish Margin Requirements for the TBA Market, Exchange Act Release No. 76148 (Oct. 14, 2015), 80 Fed. Reg. 636303 (Oct. 20, 2015) (proposing 60+120 day period following SEC approval).

[4] Letter dated November 10, 2015 from SIFMA to Robert W. Errett, SEC at pp. 14-15.

[5] Among other things, we note in particular that the Proposal presents open questions that are very significant to both legal documentation and operational processes – *e.g.*, provisions as to which counterparties are subject to margin collection, and the timing of capital charges, margin collection, and liquidation.

[6] Among others, banks and non-U.S. firms continue to have avenues to transact in CATs without being subject to the margin collection or capital costs that are imposed under FINRA rules.

arrangements they are willing to entertain given available resources. Further, even if these smaller and mid-sized broker-dealers are permitted to take capital charges (albeit in limited circumstances), many of them do not have the ability to absorb the dollar-for-dollar capital charges imposed by the rule.[7] We have heard these concerns particularly from firms which do not self-clear, and instead clear through a third-party agent.

While SIFMA recognizes that FINRA cannot solve all of these issues (in particular, the requirements applicable to non-FINRA members) and appreciates that FINRA has taken steps to address some of these competitive balance issues, the Proposal as drafted is likely to reduce participation, potentially materially, by these firms in the market. These firms, while individually engaging in lower volumes of transactions than any individual primary dealer or other larger firm, are an important component of the U.S. housing finance ecosystem. They often serve different roles than the larger firms (*e.g.*, they may focus on smaller bank or investor counterparties) or may focus on different products *(e.g.*, specified pools or CMO distribution vs. block-size to-be-announced ("**TBA**") trading). While the contribution of any individual firm to overall market liquidity may be low, the exit or significant reduction of activity by a number of these firms could impact overall market liquidity, and reduce access to the CAT market for end users. Accordingly, we believe that FINRA must consider the extent to which the Proposal will impact the mortgage markets and balance the costs borne by these firms with benefits FINRA believes the rule provides.

B. *Liquidation Requirement*. A number of SIFMA members raised concerns about the imposition of a requirement to liquidate counterparties,[8] particularly in the case of transactions in specified pools or collateralized mortgage obligations. In these markets, participants are dependent on a chain of physical deliveries of specific securities along a chain of market participants. The specific pools required to be delivered are not fungible and there may be material differences in how firms value them. Requiring broker-dealers to liquidate counterparties in these circumstances will exacerbate market volatility and disruption as any break in the delivery chain will impact numerous firms. As each firm will value the securities differently, a chain of liquidations will lead to a chain of disputes. In a time of market stress, the unnecessary forced liquidation of positions will exacerbate that stress and the resulting financial disputes create substantial risk that may drive firms under. Accordingly, SIFMA urges FINRA to pause the application of any liquidation requirement to specified pools and CMOs and to undertake an in-depth examination of market mechanisms for these securities.

C. *Introducing/Clearing Issues*. Non-self-clearing firms continue to raise concerns about the treatment of customer relationships through their respective clearing firms, while firms that offer clearing services have expressed concern about regulatory uncertainty as to the treatment of margin and capital charges relating to such customer transactions. Among other things, issues arise when introducing firms' customers post margin; the holding and ability to use such assets continues to be a source of market uncertainty. SIFMA believes that FINRA should continue to facilitate dialogue among these types of firms in order to ensure that, if adopted, the CAT Margin Rules are implemented such that the interaction between these rules and the rules governing introducing-clearing relationships are further clarified, and the implementation is done in a fashion that is least disruptive to broker-dealers and their customers, particularly where the transactions benefit from an introducing relationship.

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[7] Under existing interpretations to Rule 4210, most CAT transactions require capital charges to cover only a portion of the outstanding exposure. *See* FINRA Rule 4210(e)(2)(F), Exhibit I.

[8] We stress that this concern is about a *requirement* to liquidate. In all events, firms expect to liquidate or not (to the extent of their rights), consistent with sound credit and risk management frameworks.

III. Drafting Questions and Clarifications

A number of provisions in the Proposal are substantial re-drafts of terms included in the CAT Margin Rules adopted under SR-FINRA-2015-036 and raise questions for SIFMA members in order to comply with rules in an efficient manner.

A. *Definition of "Excess Net Mark to Market Loss."* Given the importance of the provision for documentation and systems, it would be helpful if FINRA could confirm that this term permits broker-dealers to leave up to $250,000 of exposure at all times with a particular counterparty (a "threshold" in common industry documentation) or to collect the full amount if exposure is *over* that amount (a "minimum transfer amount" in common industry documentation).[9]

B. *Definition of "Net Mark to Market Loss.*" This definition reflects a rewrite of the key inputs for margin computation; members would appreciate FINRA confirming that, while it may capture other valuation processes, it would capture the calculations used under the standard form of a Master Securities Forward Transaction Agreement ("**MSFTA**").[10] In addition, SIFMA understands that the inclusion of "in the money" amounts on customer long standby positions is an option of the broker-dealer – *i.e.*, inclusion of standby positions is not required in the CAT-specific margin calculation and may continue to be independently margined under the other provisions of Rule 4210.

C. *Use of Collateral Terms in "Net Mark to Market Loss."* SIFMA requests that FINRA remove the phrase "legally enforceable right of offset or security," as it implies a netting standard that is not present in any other aspect of Rule 4210 and raises questions about legal diligence for margin arrangements that is beyond the scope of proposal. In addition, in order to reduce some uncertainty among market participants, it would be helpful if FINRA could further explain the use of the phrase "first-priority perfected security interest" and confirm SIFMA's understanding that it applies only to pledges of CATs with third parties rather than to margin cash or securities posted to the broker-dealer.

D. *Definition of "Non-Margin Counterparty*." In the first instance, SIFMA requests that FINRA clarify the overall purpose of this definition. It is used in a limited context in the capital charge provisions and it is not clear what purpose distinguishing this group of counterparties serves (as highlighted further in Section III). If the term is to remain, SIFMA members have concerns with multiple aspects of the term. First, the written agreement provision should be removed or rewritten. As drafted, it effectively requires imposing a margin collection timing that is stricter than that which is required under the rules (or other aspects of Rule 4210 generally) – *i.e.*, five business days rather than the standard under Rule 4210(f)(6).[11] Second, FINRA should confirm that the use of "have a right…to liquidate" includes the ability (though not necessarily the actual

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[9] As a practical matter, based on the originally adopted CAT Margin Rules, most market participants have not agreed to "thresholds" and expect to continue to treat the $250,000 allowance as a "minimum transfer amount."

[10] For the avoidance of doubt, this request is simply about certainty for industry-standard language. SIFMA does not believe the rule should impose a single form of calculations/valuations and parties should be free to agree on terms that satisfy the rules.

[11] Providing that "[t] amount of margin or 'mark to market' required by any provision of this Rule shall be obtained as promptly as possible and in any event within 15 business days from the date such deficiency occurred, unless FINRA has specifically granted the member additional time."

Further to the point on implementation timing: including requirements such as this one, which diverge from standard practices and result in significant diligence and re-negotiation will increase the cost and burden of implementation.

action) to exercise default remedies following a failure to transfer margin. Third, FINRA should clearly exclude "small cash counterparties" as well as other types of counterparties excluded from margin collection and capital charges under clause (ii)(a)(1) (*e.g.*, sovereigns) from the definition of "non-margin counterparty."

IV. New Capital Charge Provisions

SIFMA members generally appreciated FINRA's providing of an exception to permit broker-dealers to take capital charges in lieu of margin for CATs. An exception is appropriate in light of the nature of the products and the transactions in the market. It is further consistent with other provisions in Rule 4210 that permit broker-dealers to take capital charges in lieu of collecting margin for transactions in instruments of high credit quality.

The new provisions, however, do raise a number of questions which are highlighted below.

A. *Treatment of Small Cash Counterparties*. Proposed Rule 4210(e)(2)(H)(ii)(a)(1) excludes small cash counterparties from the requirement to collect margin or take capital charges. However, as noted above, it is not clear whether such firms might be also captured by the definition of "non-margin counterparty" and would be counted toward the $25/30 million limits established in Proposed Rule 4210(e)(2)(H)(ii)(d). SIFMA requests that FINRA clarify that small cash counterparties' exposures do <u>not</u> count toward this limit on capital charges.

In addition, SIFMA requests that FINRA exclude these exposures from being added back in for purposes of the concentration limits in the proposed amendments to Rule 4210(e)(2)(I).[12] Adding these exposures, which are excluded for purposes of capital charges otherwise, would have the effect of severely limiting the use of the exception. In addition, for all firms, it would present an added systems and operational complication, as it would create a set of counterparties for which no capital charges are required but which must be counted for purposes of the capital charge concentrations.[13]

B. *Treatment of Counterparties Yet to Post Margin*. Under Proposed Rule 4210(e)(2)(H)(ii)(d)(3), a broker-dealer is required to count toward the $25/30 million limits "unmargined excess net mark to market loss" on a T+1 basis.[14] This requirement would have a significant negative impact on many firms. Many counterparties that are regularly margined may be unable to post margin on a T+1 basis (*e.g.*, those in overseas jurisdictions or where custodial/operational issues make this impossible), and a broker-dealer, acting consistently with its credit policies, may permit this timing. In addition, disputes over valuations (and thus margin calls) happen frequently in CATs and the full amount calculated and called for a broker-dealer may not always be immediately satisfied.[15] These types of ordinary course exposures should not count toward the limit, even if a capital charge is required on a T+1 basis. This issue would be particularly problematic for firms with large businesses in CATs, where outstanding exposures

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[12] The Proposal also makes the sub-heading for clause 4210(e)(2)(I) inconsistent with what the provision does – it is not simply a limit on net capital deductions.

[13] A similar request applies in the case of "*de minimis*" amounts under $250,000; it will be costly for firms to implement systems that disregard such amounts for purposes of capital charges but are added in for purposes of the concentration limits.

[14] Through reference to Proposed Rule 4210(e)(2)(H)(ii)(d)(1). In addition, we note that a similar concern arises in the context of the concentration limits in Rule 4210(e)(2)(I).

[15] We note that FINRA has previously recognized that presence of *bona fide* pricing disputes in these market. *See* Questions 2-3 of the FINRA CAT FAQs.

of $25/30 million may be a small amount relative to the size of the overall business. Such firms would effectively be in the position of being required to comply with clause (d)(3) on a permanent basis[16] and would need to cease transacting with *all* non-margin counterparties[17] and impose a five-business-day liquidation requirement even if unnecessary from a credit standpoint and disruptive to markets.[18] It will be practically very difficult for firms to cease all transactions with non-margin counterparties on an immediate basis. In addition, the timing aspects remain confusing. Given that a five business day period applies before the $25/30 million triggers arises, the five business day liquidation requirement that applies as a result of the capital charge trigger should only begin *after* the capital charge trigger period has passed.[19]

C. *Liquidation Standard.* Proposed Rule 4210(e)(2)(H)(ii)(d)(3) requires, in circumstances where capital charge limits are breached, that a broker-dealer "promptly liquidate the [CATs] of *any counterparty* whose excess net mark to market loss is not margined or eliminated within five business days from the date it arises" (emphasis added). As drafted, this could be read to suggest that a broker-dealer liquidate *all* such counterparties, rather than amounts sufficient to move back below the capital charge limits. SIFMA requests that FINRA clarify the language to make clear that a broker-dealer only needs to liquidate positions (with the relevant positions determined by the broker-dealer in its sole discretion) as might be necessary to move below the relevant limits.

D. *Reporting Requirements for Unmargined Counterparties.* Proposed Rule 4210(e)(2)(H)(ii)(d)(4) provides that a broker-dealer must submit certain information to FINRA as prescribed in a Regulatory Notice or similar communication. As noted before, the building of systems and information tracking is a significant build for many firms. FINRA should clarify in advance what information may be required through rulemaking.

E. *Exclusion for Sovereign and Other Counterparties.* As previously suggested in a comment letter on the original proposal, SIFMA continues to believe that the market would benefit from expanding the scope of the "sovereign" exception to include U.S. Federal Home Loan Banks. Many of such entities' obligations are guaranteed by the U.S. government, explicitly or implicitly. Furthermore, these entities are integral to the mortgage market and significant participants in the CAT market.

V. Existing FAQs re: SEC Financial Responsibility Rules

In connection with the initial adoption of the CAT Margin Rules, FINRA issued two sets of FAQs on Covered Agency Transactions.[20] SIFMA requests that FINRA clarify in advance how these FAQs will apply in

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[16] For many of these firms, the notice requirement in clause (d)(3) is further odd given that the exposure would not be extraordinary or unusual.

[17] Again, this creates another systems disruption as firms would have to impose new methods for categorizing counterparties that would be unusual and inconsistent with existing practices the requirements of Rule 4210 more generally.

[18] As noted in Section II.B, the liquidation requirement has significant downstream effects in the market; if larger broker-dealers are effectively required to impose a five-business-day period, then that would further exacerbate the problem.

[19] As stressed in note 8 *supra*, SIFMA's concern is about *forced* liquidations. A broker-dealer may continue to determine whether or not to terminate/liquidate transactions of a counterparty that has failed to provide required margin, consistent with its credit and margin policies.

[20] *Available at* https://www.finra.org/rules-guidance/guidance/faqs/responses-frequently-asked-questions-regarding-covered-agency-transactions-under-finra-rule.

the event that the Proposal is adopted. This is particularly the case for the interpretations of Exchange Act Rules 15c3-1 and 15c3-3. Firms take great care in establishing systems and technology to comply with these rules and any changes in interpretations could be very time-consuming and costly to implement.

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SIFMA appreciates the opportunity to comment on the Proposal. Should you have any questions regarding our comments, please do not hesitate to contact the undersigned at [redacted] or [redacted].

Sincerely,

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Securitization, Corporate Credit, Libor

cc: Michael A. Macchiaroli, Associate Director, Division of Trading and Markets
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