SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-94013; File No. SR-FINRA-2021-010)

January 20, 2022

Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Order Granting Approval of a Proposed Rule Change, as Modified by Amendment No. 1, to Amend the Requirements for Covered Agency Transactions under FINRA Rule 4210 (Margin Requirements) as Approved Pursuant to SR-FINRA-2015-036

I. Introduction

On May 7, 2021, the Financial Industry Regulatory Authority, Inc. ("FINRA") filed with the Securities and Exchange Commission ("Commission" or "SEC"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act" or "Exchange Act")[1] and Rule 19b-4 thereunder,[2] a proposed rule change to amend the requirements for covered agency transactions under FINRA Rule 4210.[3] The proposed rule change was published for comment in the Federal Register on May 25, 2021.[4] The Commission received comments in response to the Notice.[5] On June 30, 2021, FINRA extended the time period in which the Commission must approve the proposed rule change, disapprove the proposed rule change, or institute proceedings to determine whether to approve or disapprove the proposed rule change to August 23, 2021.[6] On August 9, 2021, FINRA responded to the comments and submitted Amendment No. 1 to the proposed rule

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1 15 U.S.C. 78s(b)(1).

2 17 CFR 240.19b-4.

3 The full text of the proposed rule change and the exhibits filed by FINRA (collectively referred to as the "Proposal") are available at: https://www.finra.org/sites/default/files/2021-05/sr-finra-2021-010.pdf.

4 See Exchange Act Release No. 91937 (May 19, 2021), 86 FR 28167 ("Notice").

5 Comments received on the Notice are available at: https://www.sec.gov/comments/sr-finra-2021-010/srfinra2021010.htm.

6 See Extension No. 1, available at: https://www.finra.org/sites/default/files/2021-06/SR-FINRA-2021-010-extension1.pdf.

change.[7] The Commission subsequently issued an Order Instituting Proceedings ("OIP") to determine whether to approve or disapprove the proposed rule change, as modified by Amendment No. 1.[8] The Commission received additional comment letters in response to the OIP.[9] On September 16, 2021, FINRA responded to these additional comment letters.[10] On October 26, 2021, FINRA extended the time period in which the Commission must approve or disapprove the proposed rule change to January 20, 2022.[11] This order approves the proposed rule change, as modified by Amendment No. 1.

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[7] See Amendment No. 1 to the proposed rule change, dated August 9, 2021 ("Amendment No. 1"). The full text of Amendment No. 1 is available on the Commission's website at: https://www.sec.gov/comments/sr-finra-2021-010/srfinra2021010-9147461-247526.pdf.

[8] See Notice of Filing of Amendment No. 1 and Order Instituting Proceedings to Determine Whether to Approve or Disapprove a Proposed Rule Change, as Modified by Amendment No. 1, 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. 92713 (Aug. 20, 2021), 86 FR 47655 (Aug. 26, 2021).

[9] Comments received on the OIP are available on the Commission's website at: https://www.sec.gov/comments/sr-finra-2021-010/srfinra2021010.htm.

[10] See Letter to Vanessa Countryman, Secretary, Commission, from Adam Arkel, Associate General Counsel, Office of General Counsel, FINRA (Sep. 16, 2021) ("FINRA Letter"), available at: https://www.sec.gov/comments/sr-finra-2021-010/srfinra2021010-9244962-250787.pdf.

[11] See Extension No. 2, available at https://www.finra.org/sites/default/files/2021-10/sr-finra-2021-010-extension2.pdf.

II. Description of the Proposed Rule Change

A. Summary of Proposed Amendments

FINRA has proposed revisions to the Covered Agency Transaction[12] requirements as approved pursuant to SR-FINRA-2015-036.[13] Broadly, FINRA has proposed:

- To eliminate the two percent maintenance margin requirement that applies to non-exempt[14] accounts pursuant to paragraph (e)(2)(H)(ii)e. under FINRA Rule 4210. This

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[12] Covered Agency Transactions are: (1) To Be Announced ("TBA") transactions, inclusive of adjustable rate mortgage ("ARM") transactions; (2) Specified Pool Transactions; and (3) transactions in Collateralized Mortgage Obligations ("CMOs"), issued in conformity with a program of an agency or Government-Sponsored Enterprise ("GSE"), with forward settlement dates transactions"). The proposed rule change would re-designate the current definition of Covered Agency Transactions, as set forth in paragraph (e)(2)(H)(i)c., as paragraph (e)(2)(H)(i)b., without any change. See Exhibit 5 to the Proposal. See also Notice, 86 FR at 28161-62.

[13] See Exchange Act Release No. 78081 (June 15, 2016), 81 FR 40364 (June 21, 2016) (Notice of Filing of Amendment No. 3 and Order Granting Accelerated Approval to a Proposed Rule Change to Amend FINRA Rule 4210 (Margin Requirements) to Establish Margin Requirements for the TBA Market, as Modified by Amendment Nos. 1, 2, and 3; File No. SR-FINRA-2015-036) (approving SR-FINRA-2015-036, referred to as the "2016 Approval Order"). The rule text as approved in the 2016 Approval Order is referred to in this order as the "current rule" or "original rulemaking." The proposed rule change, as described in Section II.A. and B., is excerpted, in part, from the Notice, which was substantially prepared by FINRA.

[14] The term "exempt account" is defined under FINRA Rule 4210(a)(13). Broadly, an exempt account means a FINRA member, non-FINRA member registered broker-dealer, account that is a "designated account" under FINRA Rule 4210(a)(4) (specifically, a bank as defined under Exchange Act Section 3(a)(6), a savings association as defined under Section 3(b) of the Federal Deposit Insurance Act, the deposits of which are insured by the Federal Deposit Insurance Corporation, an insurance company as defined under Section 2(a)(17) of the Investment Company Act, an investment company registered with the Commission under the Investment Company Act, a state or political subdivision thereof, or a pension plan or profit sharing plan subject to the Employee Retirement Income Security Act or of an agency of the United States or of a state or political subdivision thereof), and any person that has a net worth of at least $45 million and financial assets of at least $40 million for purposes of paragraphs (e)(2)(F), (e)(2)(G) and (e)(2)(H) of the rule, as set forth under paragraph (a)(13)(B)(i) of FINRA Rule 4210,

would eliminate the need for members to distinguish exempt account customers from other customers ("non-exempt accounts") for purposes of Covered Agency Transaction margin. As such, without regard to a counterparty's exempt or non-exempt account status, members would collect margin for each counterparty's excess mark to market loss, as discussed in further detail below, unless otherwise provided by the rule;

- Subject to specified conditions and limitations, to permit members to take a capital charge in lieu of collecting margin for excess net mark to market losses on Covered Agency Transactions. FINRA has designed these conditions and limitations to help protect the financial stability of members that opt to take capital charges while restricting the ability of the larger members to use their capital in lieu of collecting margin to compete unfairly with smaller members;[15] and
- To make revisions designed to streamline, consolidate and clarify the Covered Agency Transaction rule language. FINRA believes these revisions will preserve and clarify key exceptions to the requirements, including for example the $250,000 de minimis transfer

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and meets specified conditions as set forth under paragraph (a)(13)(B)(ii). See Notice, 86 FR at 28163, n.18.

15 See Notice, 86 FR at 28163.

exception[16] and the $10 million gross open position exception[17] established pursuant to SR-FINRA-2015-036.[18]

The proposed amendments are discussed in detail below.[19]

B. Detailed Discussion of Proposed Amendments

1. Elimination of Maintenance Margin Requirement; Application of Mark to Market Loss to Both Exempt and Non-Exempt Accounts

Paragraph (e)(2)(H)(ii)e. of current FINRA Rule 4210 addresses Covered Agency Transactions with counterparties that are non-exempt accounts and broadly provides that maintenance margin, defined under the current rule to mean margin equal to two percent of the contract value of the net long or net short position, by CUSIP, with the counterparty, plus any net mark to market loss on such transactions, shall be required margin, subject to specified exceptions under the rule.[20] By contrast, paragraph (e)(2)(H)(ii)d. of the current rule broadly

[16] See Notice, 86 FR at 28163. Subject to specified conditions, the current rule provides for an aggregate $250,000 de minimis transfer amount with a single counterparty, so that if the aggregate required but uncollected maintenance margin or mark to market loss does not exceed that amount, the margin need not be collected or charged to net capital. See 2016 Approval Order, 81 FR at 40367; see also paragraph (e)(2)(H)(ii)f. of the current rule in Exhibit 5 to the Proposal.

[17] The current rule provides that the margin requirements for Covered Agency Transactions do not apply to a counterparty that has gross open positions in Covered Agency Transactions with the member amounting to $10 million or less if the counterparty regularly settles its Covered Agency Transactions on a Delivery Versus Payment ("DVP") basis or for cash and meets other specified conditions. See paragraph (e)(2)(H)(ii)c. of the current rule in Exhibit 5 to the Proposal.

[18] See Notice, 86 FR at 28163.

[19] Section II.B. describes the proposed rule change prior to the proposed amendments in Amendment No. 1, which are summarized in Section II.C. below.

[20] See 2016 Approval Order, 81 FR at 40367; see also paragraph (e)(2)(H)(ii)e. of the current rule in Exhibit 5. The rule further sets forth specified requirements for net capital deductions and the liquidation of positions in the event the uncollected maintenance margin and mark to market loss (defined together under paragraph (e)(2)(H)(i)d. of the current rule as the "deficiency") is not satisfied. In short, the rule provides that if the

provides that on transactions with counterparties that are exempt accounts no maintenance margin shall be required. Such transactions must be marked to the market daily and the member must collect any net mark to market loss, subject to specified exceptions under the current rule.[21]

According to FINRA, member firms expressed concern that the two-track treatment of exempt versus non-exempt accounts is burdensome because members are obliged under the current rule to obtain and assess the financial information needed to determine which counterparties must be treated as non-exempt accounts.[22] Further, based on feedback from members since the approval date and additional observation of market conditions, FINRA

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deficiency is not satisfied by the close of business on the next business day after the business day on which the deficiency arises, the member shall be required to deduct the amount of the deficiency from net capital as provided in Exchange Act Rule 15c3-1 until such time the deficiency is satisfied; under the rule, if such deficiency is not satisfied within five business days from the date the deficiency was created, the member must promptly liquidate positions to satisfy the deficiency, unless FINRA has specifically granted the member additional time. As discussed in further detail below, the proposed rule change would eliminate current paragraph (e)(2)(H)(ii)e. in its entirety.

21 See 2016 Approval Order, 81 FR at 40367; see also paragraph (e)(2)(H)(ii)d. of the current rule in Exhibit 5 to the Proposal. Similar to paragraph (e)(2)(H)(ii)e., the current rule provides that if the mark to market loss is not satisfied by the close of business on the next business day after the business day on which the mark to market loss arises, the member is required to deduct the amount of the mark to market loss from net capital as provided in Exchange Act Rule 15c3-1 until such time the mark to market loss is satisfied; if such mark to market loss is not satisfied within five business days from the date the loss was created, the member must promptly liquidate positions to satisfy the mark to market loss, unless FINRA has specifically granted the member additional time. Again, as discussed in further detail below, the proposed rule change would eliminate current paragraph (e)(2)(H)(ii)d. in its entirety.

22 See Notice, 86 FR at 28163. Further, members expressed concern that some asset manager counterparties face constraints with regard to custody of assets at broker-dealers and that, because of these constraints, some members need to enter into separate custodial agreements with third party banks to hold the maintenance margin that they collect from these asset managers. Members expressed concern that this imposes operational burdens both on themselves and their client counterparties, who may, as a consequence, choose to limit their dealings with smaller broker-dealers. Id., at n.23.

believes that the potential risk that the maintenance margin requirement was intended to address when originally proposed is not significant enough to warrant the burdens and competitive disadvantage that the requirement imposes.[23] According to FINRA, members pointed out that, in practice, the maintenance margin requirement would apply to relatively few accounts that participate in the Covered Agency Transaction market. Yet, FINRA believes that monitoring and collecting maintenance margin for such accounts is operationally burdensome and out of proportion with the number and size of the affected accounts.[24] Further, according to FINRA, bank dealers are not subject to the requirement to collect maintenance margin from their customers, which would significantly disadvantage FINRA members in competition with bank dealers.[25] To address these concerns, FINRA is proposing to eliminate paragraph (e)(2)(H)(ii)d. and paragraph (e)(2)(H)(ii)e. of FINRA Rule 4210 as established pursuant to the 2016 Approval Order, and to adopt in lieu new paragraph (e)(2)(H)(ii)c., which provides that members shall

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23 See Notice, 86 FR at 28163.

24 Id.

25 Id.

collect margin for each counterparty's[26] excess net mark to market loss,[27] unless otherwise provided under proposed new paragraph (e)(2)(H)(ii)d. of the rule, as discussed further below.

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[26] Current paragraph (e)(2)(H)(i)b. defines the term "counterparty" to mean any person that enters into a Covered Agency Transaction with a member and includes a "customer" as defined in paragraph (a)(3) under FINRA Rule 4210. The proposed rule change would redesignate the definition of counterparty as paragraph (e)(2)(H)(i)a. under the rule and revise the definition to provide that the term "counterparty" means any person, including any "customer" as defined in paragraph (a)(3) of the rule, that is a party to a Covered Agency Transaction with, or guaranteed by, a member. FINRA believes that including transactions guaranteed by a member is a useful clarifying change in the context of Covered Agency Transactions. In connection with this change, FINRA proposes to add new Supplemental Material .02, which would provide that, for purposes of paragraph (e)(2)(H), a member is deemed to have "guaranteed" a transaction if the member has become liable for the performance of either party's obligations under the transaction. <u>See</u> proposed new Supplemental Material .02 in Exhibit 5 to the Proposal. Accordingly, if a clearing broker were to guarantee to an introduced customer an introducing broker's obligations under a Covered Agency Transaction between that introducing firm and customer, the introducing broker would be considered a "counterparty" of the clearing broker for purposes of paragraph (e)(2)(H). <u>See also</u> Notice, 86 FR at 28163-64, n.25.

[27] FINRA proposes to delete the current definition of "mark to market loss" under paragraph (e)(2)(H)(i)g. as adopted pursuant to the 2016 Approval Order and to replace it with a definition of "net mark to market loss" under proposed new paragraph (e)(2)(H)(i)d. Under the new definition, a counterparty's "net mark to market loss" means (1) the sum of such counterparty's losses, if any, resulting from marking to market the counterparty's Covered Agency Transactions with the member, or guaranteed to a third party by the member, reduced to the extent of the member's legally enforceable right of offset or security by (2) the sum of such counterparty's gains, if any, resulting from: (a) marking to market the counterparty's Covered Agency Transactions with the member, guaranteed to the counterparty by the member, cleared by the member through a registered clearing agency, or in which the member has a first-priority perfected security interest; and (b) any "in the money," as defined in paragraph (f)(2)(E)(iii) of FINRA Rule 4210, amounts of the counterparty's long standby transactions written by the member, guaranteed to the counterparty by the member, cleared by the member through a registered clearing agency, or in which the member has a first-priority perfected security interest. Under proposed new paragraph (e)(2)(H)(i)c., a counterparty's "excess" net mark to market loss is defined to mean such counterparty's net mark to market loss to the extent it exceeds $250,000. As such, by specifying excess net mark to market loss, FINRA stated that the proposed rule preserves the $250,000 de minimis transfer exception set forth under paragraph (e)(2)(H)(ii)f. as adopted pursuant to the 2016 Approval Order. Further, FINRA stated that, in the interest of clarity, proposed new paragraph (e)(2)(H)(ii)c. expressly provides that members would not be required to collect margin, or take capital charges, for counterparties' mark to market losses on

As such, both exempt and non-exempt accounts would receive the same margin treatment for purposes of Covered Agency Transactions under paragraph (e)(2)(H).[28]

2. Option for Capital Charge in Lieu of Mark to Market Margin

Proposed new paragraph (e)(2)(H)(ii)d. of the rule is designed, subject to specified conditions and limitations, to permit members the option to take a capital charge in lieu of collecting margin for a counterparty's excess net mark to market loss (that is, as discussed above, the net mark to market loss to the extent it exceeds $250,000). Informed by FINRA's engagement with members, FINRA believes this approach is appropriate because it would help alleviate the competitive disadvantage of smaller firms vis-à-vis larger firms.[29] According to FINRA, smaller firms expressed concern that larger firms can leverage their greater size and scale in obtaining margining agreements with their counterparties, and that counterparties would prefer to transact with larger firms with which margining agreements can more readily be obtained, or with banks that are not subject to margin requirements under FINRA Rule 4210. Smaller firms told FINRA that having the option to take a capital charge, in lieu of collecting margin, would help alleviate the competitive disadvantage of needing to obtain margining agreements with such counterparties because there would be an alternative to collecting

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Covered Agency Transactions other than excess net mark to market losses. Last, as discussed further below, the proposed rule change would delete paragraph (e)(2)(H)(ii)f. in the interest of consolidating the rule language. See Notice, 86 FR at 28164, n.26.

28 Current paragraph (e)(2)(H)(ii)d. of the rule contains provisions designed to permit members to treat mortgage bankers, as defined pursuant to current paragraph (e)(2)(H)(i)h. of the rule, as exempt accounts under specified conditions. Because the proposed rule change eliminates the distinction between exempt and non-exempt accounts for purposes of Covered Agency Transactions, FINRA believes this language is no longer needed and will be deleted. See Notice, 86 FR at 28164, n.27.

29 See Notice, 86 FR at 28164.

margin.[30] To this end, as stated above, the proposed rule change includes conditions and limitations that FINRA believes are designed to help protect the financial stability of members that opt to take capital charges while restricting the ability of the larger members to use their capital to compete unfairly with smaller members.[31] Specifically, the proposed new paragraph provides that a member need not collect margin for a counterparty's excess net mark to market loss under paragraph (e)(2)(H)(ii)c. of the rule, provided that:

- The member must deduct the amount of the counterparty's unmargined excess net mark to market loss from the member's net capital computed as provided in Exchange Act Rule 15c3-1, if the counterparty is a non-margin counterparty[32] or if the excess net mark to market loss has not been margined or eliminated by the close of business on the next business day after the business day on which such excess net mark to market loss arises;[33]
- If the member has any non-margin counterparties, the member must establish and enforce risk management procedures reasonably designed to ensure that the member would not exceed either of the limits specified in paragraph (e)(2)(I)(i) of the rule, as proposed to be revised pursuant to this rule change,[34] and that the member's net capital deductions under

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30 See Notice, 86 FR at 28164.

31 See Notice, 86 FR at 28164.

32 Proposed new paragraph (e)(2)(H)(i)e. defines a counterparty as a "non-margin counterparty" if the member: (1) does not have a right under a written agreement or otherwise to collect margin for such counterparty's excess net mark to market loss and to liquidate such counterparty's Covered Agency Transactions if any such excess net mark to market loss is not margined or eliminated within five business days from the date it arises; or (2) does not regularly collect margin for such counterparty's excess net mark to market loss. See Amendment No. 1 discussed in Section II.C. below for discussions of modification to proposed definition of non-margin counterparty.

33 See proposed paragraph (e)(2)(H)(ii)d.1. in Exhibit 5 to the Proposal.

34 Current paragraph (e)(2)(I) sets forth specified concentration thresholds. As discussed

proposed paragraph (e)(2)(H)(ii)d.1. of the rule for all accounts combined will not exceed $25 million;[35]

- If the member's net capital deductions under paragraph (e)(2)(H)(ii)d.1. of the rule for all accounts combined exceed $25 million for five consecutive business days, the member must give prompt written notice to FINRA. If the member's net capital deductions under paragraph (e)(2)(H)(ii)d.1. of the rule for all accounts combined exceed the lesser of $30 million or 25% of the member's tentative net capital, as such term is defined in Exchange Act Rule 15c3-1, for five consecutive business days, the member may not enter into any new Covered Agency Transactions with any non-margin counterparty other than risk-reducing transactions, and must also, to the extent of its rights, promptly collect margin for each counterparty's excess net mark to market loss and promptly liquidate the Covered Agency transactions of any counterparty whose excess net mark to market loss is not margined or eliminated within five business days from the date it arises, unless FINRA has specifically granted the member additional time;[36] and
- The member must submit to FINRA such information regarding its unmargined net mark to market losses, non-margin counterparties and related capital charges, in such form and manner, as FINRA shall prescribe by Regulatory Notice or similar communication.[37]

3. Streamlining and Consolidation of Rule Language; Conforming Revisions

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further below, the rule change would make conforming revisions to the rule.

35 See proposed paragraph (e)(2)(H)(ii)d.2. in Exhibit 5 to the Proposal.

36 See proposed paragraph (e)(2)(H)(ii)d.3. in Exhibit 5 to the Proposal.

37 See Notice, 86 FR at 28164. See also proposed paragraph (e)(2)(H)(ii)d.4. in Exhibit 5 to the Proposal.

In support of the amendments discussed above, FINRA has proposed several amendments to the current rule designed to streamline and consolidate the rule language and otherwise make conforming revisions:

- The rule change consolidates language related to the $250,000 de minimis transfer exception and the $10 million gross open position exception while, as discussed above, preserving these exceptions in substance. The $250,000 de minimis transfer exception is preserved because paragraph (e)(2)(H)(ii)c. under the revised rule specifies that the members shall collect margin for each counterparty's excess net mark to margin loss, unless otherwise provided under paragraph (e)(2)(H)(ii)d. of the rule (that is, as discussed above, the provisions under the proposed rule change that permit a member to take a capital charge in lieu of collecting margin, subject to specified conditions).[38] The proposed rule change deletes paragraph (e)(2)(H)(ii)f., which currently addresses the de minimis exception and would be rendered redundant. With respect to the current $10 million gross open position exception, FINRA proposes to revise paragraph (e)(2)(H)(ii)a. of the rule, which specifies counterparties that are excepted from the rule's margin requirements, to include a "small cash counterparty" among the enumerated entities included in the exception. Proposed new paragraph (e)(2)(H)(i)h. would provide that a counterparty is a "small cash counterparty" if:
    - The absolute dollar value of all of such counterparty's open Covered Agency Transactions with, or guaranteed by, the member is $10 million or less in the aggregate, when computed net of any settled position of the

[38] See Notice, 86 FR at 28165.

counterparty held at the member that is deliverable under such open Covered Agency Transactions and which the counterparty intends to deliver;[39]

- The original contractual settlement date for all such open Covered Agency Transactions is in the month of the trade date for such transactions or in the month succeeding the trade date for such transactions;[40]
- The counterparty regularly settles its Covered Agency Transactions on a DVP basis or for cash;[41] and
- The counterparty does not, in connection with its Covered Agency Transactions with, or guaranteed by, the member, engage in dollar rolls, as defined in Rule 6710(z), or round robin trades,[42] or use other financing techniques.[43]

The above elements, according to FINRA, are substantially similar to the elements that are currently associated with the exception as set forth under current paragraph (e)(2)(H)(ii)c.2., which would be deleted, along with the definition of "gross open position" under paragraph (e)(2)(H)(i)e., which would be rendered redundant.[44] The new

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39 See proposed paragraph (e)(2)(H)(i)h.1. in Exhibit 5 to the Proposal.

40 See proposed paragraph (e)(2)(H)(i)h.2. in Exhibit 5 to the Proposal.

41 See proposed paragraph (e)(2)(H)(i)h.3. in Exhibit 5 to the Proposal.

42 The term "round robin" is defined under current paragraph (e)(2)(H)(i)i. of the rule and, pursuant to the rule change, would be redesignated as paragraph (e)(2)(H)(i)g., without any change.

43 See proposed paragraph (e)(2)(H)(i)h.4. in Exhibit 5 to the Proposal.

44 See Notice, 86 FR at 28165.

proposed language reflects that the scope of transactions addressed by the rule include Covered Agency Transactions with a counterparty that are guaranteed by the member.

- FINRA proposes to delete the definition of "bilateral transaction" set forth in current paragraph (e)(2)(H)(i)a. The definition is in connection with the provisions under the current rule relating to margin treatment for exempt accounts under paragraph (e)(2)(H)(ii)d. and for non-exempt accounts under paragraph (e)(2)(H)(ii)e., both of which paragraphs, as discussed above, FINRA proposes to delete pursuant to the rule change. Further, FINRA notes that the term "bilateral transaction" is unduly narrow given that the proposed revised definition of "counterparty," as discussed above, would have the effect of clarifying that the rule's scope includes transactions guaranteed by the member.[45]
- FINRA proposes to delete the definition of the term "deficiency" set forth in current paragraph (e)(2)(H)(i)d. Under the current rule, the term is designed in part to reference required but uncollected maintenance margin for Covered Agency Transactions. Because the rule change proposes to eliminate such maintenance margin, FINRA believes that the term is not needed.[46]
- Current paragraph (e)(2)(H)(ii)a. addresses the scope of paragraph (e)(2)(H) and certain types of counterparties that are excepted from the rule, provided the member makes and enforces written risk limits pursuant to paragraph (e)(2)(H)(ii)b. Current paragraph (e)(2)(H)(ii)b. contains the core language under the rule relating to risk limits. FINRA is proposing to revise both paragraphs so as to conform with the rule change and to

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45 See Notice, 86 FR at 28165.

46 See Notice, 86 FR at 28165.

consolidate the language relating to written risk limits in these paragraphs within paragraph (e)(2)(H)(ii)b. Paragraph (e)(2)(H)(ii)a.1. would be revised to read: "1. a member is not required to collect margin, or to take capital charges in lieu of collecting such margin, for a counterparty's excess net mark to market loss if such counterparty is a small cash counterparty, registered clearing agency, Federal banking agency, as defined in 12 U.S.C. 1813(z), central bank, multinational central bank, foreign sovereign, multilateral development bank, or the Bank for International Settlements; and . . ."[47] Paragraph (e)(2)(H)(ii)a.2. would be revised to read: "2. a member is not required to include a counterparty's Covered Agency Transactions in multifamily housing securities or project loan program securities in the computation of such counterparty's net mark to market loss, provided . . ."[48] Paragraph (e)(2)(H)(ii)a.2.A. would not be changed, other than to be redesignated as part of part of (e)(2)(H)(ii)a.2. Paragraph (e)(2)(H)(ii)a.2.B.

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[47] The proposed new term "small cash counterparty" is discussed above. The proposed language in the paragraph reflects FINRA's proposed establishment of the option to take a net capital charge in lieu of collecting margin. Further, FINRA stated that, for clarity, the proposed rule change adds registered clearing agencies to the types of counterparties that are within the exception pursuant to paragraph (e)(2)(H)(ii)a. as revised. FINRA believes that this preserves the treatment of registered clearing agencies under the rule in light of the proposed deletion of current paragraph (e)(2)(H)(ii)c. In this regard, also in the interest of clarity, FINRA proposes to add new paragraph (e)(2)(H)(i)f. by way of defining the term "registered clearing agency." See Notice, 86 FR at 28165, n.39.

[48] Under current paragraph (e)(2)(H)(ii)a.2., a member is not required to apply the margin requirements of paragraph (e)(2)(H) to Covered Agency Transactions with a counterparty in multifamily housing securities or project loan program securities, provided the securities meet the specified conditions under the rule and the member makes and enforces the written risk limit determinations as specified under the rule. FINRA stated that the proposed rule change does not change the treatment of multifamily housing securities or project loan program securities under the current rule other than to clarify, in express terms, that a member is not required to include a counterparty's Covered Agency Transactions in multifamily housing securities or project loan program securities in the computation of such counterparty's net mark to market loss. See Notice, 86 FR at 28165, n.40.

would be eliminated as redundant[49] because, correspondingly, paragraph (e)(2)(H)(ii)b. would be revised to read: "A member that engages in Covered Agency Transactions with any counterparty shall make a determination in writing of a risk limit for each such counterparty, including any counterparty specified in paragraph (e)(2)(H)(ii)a.1. of this Rule, that the member shall enforce. The risk limit for a counterparty shall cover all of the counterparty's Covered Agency Transactions with the member or guaranteed to a third party by the member, including Covered Agency Transactions specified in paragraph (e)(2)(H)(ii)a.2. of this Rule. The risk limit determination shall be made by a designated credit risk officer or credit risk committee in accordance with the member's written risk policies and procedures."[50]

- Paragraph (e)(2)(I) under FINRA Rule 4210 addresses concentration thresholds. FINRA is proposing to make revisions to align the paragraph with the proposed new language as to paragraph (e)(2)(H), in particular the elimination of the maintenance margin requirement and the introduction of the proposed new term "small cash counterparty." Specifically, FINRA proposes to revise the opening sentence of the paragraph to read: "In the event that (i) the net capital deductions taken by a member as a result of marked to the market losses incurred under paragraphs (e)(2)(F), (e)(2)(G) (exclusive of the percentage requirements established thereunder), or (e)(2)(H)(ii)d.1. of this Rule, plus any unmargined net mark to market losses below $250,000 or of small cash counterparties exceed . . ."[51] Current paragraph (e)(2)(I)(i)c. would be redesignated as (e)(2)(I)(ii) and

49 See proposed paragraph (e)(2)(H)(ii)a. in Exhibit 5 to the Proposal.

50 See proposed paragraph (e)(2)(H)(ii)b. in Exhibit 5 to the Proposal.

51 See proposed paragraph (e)(2)(I) in Exhibit 5 to the Proposal.

would read: "(ii) such excess as calculated in paragraph (e)(2)(I)(i) of this Rule continues to exist on the fifth business day after it was incurred. . ." The final clause of the paragraph would be revised to read: ". . . the member shall give prompt written notice to FINRA and shall not enter into any new transaction(s) subject to the provisions of paragraphs (e)(2)(F), (e)(2)(G) or (e)(2)(H) of this Rule that would result in an increase in the amount of such excess."

- Paragraph (f)(6) under FINRA Rule 4210 addresses the time within which margin or "mark to market" must be obtained. FINRA proposes to delete the phrase "other than that required under paragraph (e)(2)(H) of this Rule," so the rule, as revised, would read: "The 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." FINRA believes this is appropriate given the proposed elimination of current paragraph (e)(2)(H)(ii)d. and paragraph (e)(2)(H)(ii)e. of the rule, both of which set forth, among other things, specified time frames for collection of mark to market losses or deficiencies, as appropriate, and liquidation of positions that are specific to Covered Agency Transactions.[52]
- Current Supplemental Material .02 addresses the requirement for monitoring procedures with respect to mortgage bankers, for purposes of treating them as exempt accounts pursuant to current paragraph (e)(2)(H)(ii)d. Current Supplemental Material .03 addresses how the cure of mark to market loss or deficiency, as defined under the current rule, may cure the need to liquidate positions. Current Supplemental Material .04

52 See Notice, 86 FR at 28166.

addresses determining whether an account qualifies as an exempt account. The proposed rule change would render each of these provisions unnecessary, given that the rule change eliminates the need to distinguish exempt versus non-exempt accounts, including, as discussed above, the language targeted toward mortgage bankers, and eliminates the liquidation provisions under current paragraph (e)(2)(H)(ii)d. and paragraph (e)(2)(H)(ii)e. of the rule.[53] FINRA proposes to redesignate current Supplemental Material .05 as Supplemental Material .03.[54]

Subject to Commission approval of the proposed rule change, FINRA proposed it would announce the effective date of the proposed rule change in a Regulatory Notice to be published no later than 60 days following Commission approval. FINRA states that the effective date will be no later than 120 days following publication of the Regulatory Notice announcing Commission approval.[55]

C. Summary of Amendment No. 1

In Amendment No. 1, FINRA proposed the following modifications to the proposed rule change: (1) modify the definition of "non-margin counterparty" to exclude small cash counterparties and other exempted counterparties; and (2) define a FINRA member's "specified net capital deductions" as the net capital deductions required by paragraph (e)(2)(H)(ii)d.1. of

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53 See Notice, 86 FR at 28166.

54 See Supplemental Material provisions in Exhibit 5 to the Proposal.

55 See discussion of Amendment No. 1 in Sections II.C. and III.B.12. below for discussion of the proposed adjustment of the implementation date. See also Amendment No. 1 at 20. FINRA stated that the proposed rule change would not impact members that are funding portals or that have elected to be treated as capital acquisition brokers ("CABs"), given that such members are not subject to FINRA Rule 4210. See Notice, 86 FR at 28166, n.45.

FINRA Rule 4210 with respect to all unmargined excess net mark to market losses of its counterparties, except to the extent that the member, in good faith, expects such excess net mark to market losses to be margined by the close of business on the fifth business day after they arose.[56] In addition, Amendment No. 1 states that, if the Commission approves the proposed rule change, as modified by Amendment No. 1, FINRA will announce the effective date of the proposed rule change, as modified by Amendment No. 1, in a Regulatory Notice to be published no later than 60 days following Commission approval. The effective date would be between nine and ten months following the Commission's approval.[57]

III. Discussion and Commission Findings

After careful review of the proposed rule change, as modified by Amendment No. 1, comment letters, and FINRA's responses to the comments, the Commission finds that the proposed rule change, as modified by Amendment No. 1, is consistent with the requirements of the Exchange Act and the rules and regulations thereunder applicable to a national securities association.[58] Specifically, the Commission finds that the proposed rule change, as modified by Amendment No. 1, is consistent with Section 15A(b)(6) of the Exchange Act,[59] which requires, among other things, that FINRA rules be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to facilitate transactions in

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56 Amendment No. 1 also contains several conforming changes to paragraph numbering to accommodate the proposed modifications to the rule text. See Exhibit 4 to Amendment No. 1.

57 See Amendment No. 1. See also OIP, 86 FR at 47665.

58 In approving this rule change, the Commission has considered the rule's impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f). See, e.g., Section III.A. (discussing competitive concerns raised by commenters regarding smaller firms exiting the market resulting in a concentration of larger firms, and enhancements in efficiency in streamlining and consolidating the rule text).

59 15 U.S.C. 78o-3(b)(6).

securities, to remove impediments to and perfect the mechanism of a free and open market and, in general, to protect investors and the public interest.

A. Elimination of Maintenance Margin Requirement; Capital in Lieu of Margin Charges; and Streamlining of Rule Text

As discussed above in Section II, FINRA has proposed: (1) to eliminate the two percent maintenance margin requirement that would apply to non-exempt accounts under current FINRA Rule 4210; (2) subject to specified conditions and limitations, to permit FINRA members to take a capital charge in lieu of collecting margin for excess net mark to market losses on Covered Agency Transactions; and (3) to make revisions designed to streamline, consolidate and clarify the Covered Agency Transaction rule language.

Some commenters stated that they appreciated the efforts that FINRA made to modify the Covered Agency Transaction margin requirements,[60] and acknowledged the substantial efforts FINRA made to engage with industry participants and to adjust the Covered Agency Transaction margin requirements to address concerns about competitive equality, cost, and the impact on the market for mortgage securities.[61] One commenter expressed support for the proposed change eliminating the maintenance margin requirement.[62]

Some commenters, however, raised concerns or objected to the proposed rule change on the grounds that imposing margin requirements with regard to Covered Agency Transactions

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60 See Letter from Chris Melton, to Commission (Aug. 2, 2021) ("Melton Letter").

61 See Letter from Christopher B. Killian, Managing Director, Securitization, Corporate Credit, Libor, Securities Industry and Financial Markets Association, to J. Matthew DeLesDernier, Assistant Secretary, Commission (June 15, 2021) ("SIFMA Letter") at 1.

62 See Letter from Christopher B. Killian, Managing Director, Securitization, Corporate Credit, Libor, Asset Management Group of SIFMA, to Secretary, Commission (June 15, 2021) ("SIFMA AMG Letter") at 1.

would cause smaller and mid-sized firms to exit the Covered Agency Transaction market, thereby causing greater concentration among fewer market participants, reducing access to the Covered Agency Transaction market or negatively affecting market liquidity.[63] These commenters expressed concerns that customers would not be inclined to transact with smaller and mid-sized broker-dealers and would prefer to transact with banks that are not subject to margin requirements, that many customers would be unwilling to enter into margin agreements, that the costs of engaging in Covered Agency Transactions would increase significantly and excessive margin requirements and capital charges would be involved, or that the proposed requirements, either in whole or in part, are not suitable for Specified Pool Transactions and CMOs.[64] Further, in response to the OIP, one commenter reiterated its position that the amendments that are the subject of the proposed rule change are unnecessary and an abuse of discretion in that they are unworkable, increase systemic risk, and will have a catastrophic effect on regional broker-dealers, and that the proposed rule change will impose burdens on competition that are neither necessary nor appropriate.[65]

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[63] See SIFMA Letter at 2-3; Letter from Michael Decker, Senior Vice President, Public Policy, Bond Dealers of America, to Vanessa Countryman, Secretary, Commission (June 15, 2021) ("BDA Letter") at 2-5; Letter from Thomas J. Fleming & Adrienne M. Ward, Olshan, on behalf of Brean Capital, LLC, to Vanessa Countryman, Secretary, Commission (June 15, 2021) ("Brean Capital Letter") at 10-21. See also Letter from Kirk R. Malmberg, President and Chief Executive Officer, Federal Home Loan Bank of Atlanta, to Vanessa Countryman, Secretary, Commission at 1-2 (Jan. 18, 2022); Letter from Senator John Boozman, Senator Thom Tillis, and Senator Cynthia M. Lummis, to Gary Gensler, Chairman, Commission (Jan. 10, 2022) ("Boozman et al Letter") at 1-2.

[64] Id. See also Melton Letter at 1 (stating Specified Pools do not represent systemic risk in and among themselves and should not be included in the definition of "Covered Agency Transaction").

[65] See Letter from Thomas J. Fleming and Adrienne M. Ward, Olshan, and David H. Thompson and Harold Reeves, Cooper & Kirk, PLLC on behalf of Brean Capital, LLC, and the Bond Dealers of America, Inc. to Vanessa Countryman, Secretary, Commission (Sep. 10, 2021) ("BDA and Brean Capital Letter") at 20-42. The BDA and Brean Capital

In response to the comments to the Notice, FINRA stated that it has engaged with industry participants extensively on these concerns, and has addressed them on multiple occasions, since the process of soliciting comment on requirements for Covered Agency Transactions began in January 2014 with the publication of Regulatory Notice 14-02 and in 2015 with FINRA's original rulemaking for Covered Agency Transactions.[66] FINRA also stated that it believes that the rulemaking is necessary because of the risks posed by unsecured credit exposures in the Covered Agency Transactions market.[67] FINRA also stated that it has addressed, on multiple occasions, the need to include Specified Pool Transactions and CMOs within the scope of the requirements,[68] and stated that it made key revisions in finalizing the original rulemaking expressly to mitigate any potential impact on smaller firms and on activity in the Covered Agency Transaction market, including the following:

- FINRA initially proposed an exception in the original rulemaking pursuant to which the new margin requirements would not apply to a counterparty if its gross open positions in Covered Agency Transactions with a FINRA member is

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Letter appears twice in the comment file.

66 See Exchange Act Release No. 76148 (Oct. 14, 2015), 80 FR 63603 (Oct. 20, 2015) (Notice of Filing of a Proposed Rule Change to Amend FINRA Rule 4210 (Margin Requirements) to Establish Margin Requirements for the TBA Market; File No. SR-FINRA-2015-036) ("2015 Notice"); see also Regulatory Notice 14-02 (Jan. 2014). Even before the publication of these materials, as discussed in SR-FINRA-2015-036, FINRA highlighted that it had engaged in extensive outreach and consultation with market participants and staff of the Federal Reserve Bank of New York and the Commission staff. See 2015 Notice, 80 FR, at 63604-05. In Partial Amendment No. 3 to SR-FINRA-2015-036, FINRA stated that up to that point there had been four opportunities for public comment on the original rulemaking, beginning with Regulatory Notice 14-02, available at: https://www.finra.org/rules-guidance/rule-filings/sr-finra-2015-036. See also Amendment No. 1 at 4.

67 See, e.g., 2015 Notice, 80 FR at 63615-16. See also Amendment No. 1 at 4-5.

68 See 2016 Approval Order, 81 FR at 40371.

$2.5 million or less, subject to specified conditions. In response to commenters on the original rulemaking, and to ensure that a greater number of smaller firms and counterparties would benefit from the exception, FINRA increased the amount from $2.5 million to $10 million;[69]

- FINRA modified the two percent maintenance margin requirement, as adopted pursuant to the original rulemaking, to create an exception for cash investors that otherwise, by virtue of not being "exempt accounts" as defined under FINRA's margin rules, would have been subject to the requirement.[70] FINRA also made an exception from the maintenance margin requirements available to mortgage bankers in the original rulemaking;
- FINRA excepted multifamily housing securities and project loan program securities from the new margin requirements;[71]
- FINRA established a $250,000 de minimis transfer amount, for a single counterparty, subject to specified conditions, up to which members would not need to collect margin or take a charge to their net capital.[72]

Additionally, FINRA stated that the 2016 Approval Order was issued for the original rulemaking on June 15, 2016, and FINRA stated that, upon the Commission's approval (of the original rulemaking), FINRA would monitor the impact of the new requirements and, if the

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69 See Partial Amendment No. 3 to SR-FINRA-2015-036, available at: https://www.finra.org/rules-guidance/rule-filings/sr-finra-2015-036.

70 See 2015 Notice, 80 FR at 63608.

71 See Partial Amendment No. 1 to SR-FINRA-2015-036, available at: https://www.finra.org/rules-guidance/rule-filings/sr-finra-2015-036.

72 See 2016 Approval Order, 81 FR at 40368. See also Amendment No. 1 at 5-6.

requirements prove overly onerous or otherwise are shown to negatively impact the market, would consider revisiting such requirements as may be necessary to mitigate the rule's impact.[73] Industry participants requested that FINRA reconsider the potential impact of the requirements pursuant to SR-FINRA-2015-036 on smaller and mid-sized firms, and that FINRA extend the implementation date of the requirements pending such reconsideration. In response to the concerns of industry participants, FINRA engaged in extensive dialogue, both with industry participants and other regulators, including staff of Commission and the Federal Reserve System, for the purpose of reconsidering the requirements.[74] Further, FINRA has extended the implementation date of the margin collection requirements pursuant to SR-FINRA-2015-036 on multiple occasions.[75]

FINRA stated that it developed the proposed rule change in direct response to the concerns of industry participants, and in citing the risks posed by unsecured credit exposures that exist in the Covered Agency Transaction market, stated that it has proposed two key revisions designed to afford relief to industry participants.[76] Specifically, FINRA proposed to eliminate the two percent maintenance margin requirement with respect to non-exempt accounts for purposes of their Covered Agency Transactions and, subject to specified conditions and limits, to permit members to take a capital charge in lieu of collecting margin for each counterparty's excess mark to market loss.[77] FINRA believes that, over the course of prolonged engagement with industry participants, and in light of the multiple rounds of responding to concerns already

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[73] See Partial Amendment No. 3 to SR-FINRA-2015-036. See also Amendment No. 1 at 6.

[74] See Amendment No. 1 at 6.

[75] See Notice, 86 FR at 28162. See also Amendment No. 1 at 6.

[76] See Notice, 86 FR at 28162-63. See also Amendment No. 1 at 6.

[77] See Amendment No. 1 at 6-7.

expressed, and answered, in connection with the original rulemaking, and as further addressed in the proposed rule change, it does not serve the public interest to further delay the proposed rule change. FINRA believes the revisions to the original rulemaking as set forth more fully in the proposed rule change, with the additional clarifications provided to commenters, afford industry participants appropriate relief and clarity, and that the rulemaking should proceed.[78]

Further, in response to the additional comments received in response to the OIP, FINRA stated that commenters have expressed these same points repeatedly, including during the original rulemaking. FINRA further stated these concerns have repeatedly been addressed.[79] FINRA also stated that the rulemaking is necessary because of the risk posed by unsecured credit exposures in the Covered Agency Transaction market, and that FINRA has addressed concerns of industry participants in finalizing the original rulemaking, as well as through this proposed rule change.[80] FINRA also stated that events in connection with market volatility and other stress stemming from the COVID-19 pandemic have once again illustrated the importance of risk and exposure limits.[81] FINRA stated that the recent default of Archegos Capital Management, and related multi-billion dollar losses incurred by Credit Suisse, is yet another case in point. FINRA stated that these events reinforce that FINRA's attention to unsecured exposures in the Covered Agency Transaction market, in view of its significance to the U.S. mortgage market and financial system generally, is rationally founded. FINRA stated that the Covered Agency Transaction market today is substantial. As of the second quarter of 2021, FINRA stated that

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[78] See Amendment No. 1 at 7.

[79] See FINRA Letter at 3.

[80] See FINRA Letter at 4-7.

[81] See FINRA Letter at 5.

total average daily dollar trading volume for these types of products as reflected in FINRA Trade Reporting and Compliance Engine ("TRACE") data was approximately $300 billion.[82] FINRA stated that the regulatory need for attention to this area is no less than when FINRA initiated the original rulemaking.[83]

In the proposed rule change, FINRA has reasonably balanced the goal of reducing firm exposure to counterparty credit risk stemming from unsecured credit exposures in the Covered Agency Transaction market, with the potential competitive impacts and costs on smaller and medium-sized broker-dealers. The risks posed by unsecured credit exposures in the Covered Agency Transaction market justify the imposition of margin requirements on Covered Agency Transactions. Further, as highlighted by FINRA above, the current rule, as approved in the 2016 Approval Order, already incorporates a number of exceptions designed to alleviate the impact of the Covered Agency Margin requirements on smaller firms and counterparties, including the small cash counterparty exception.[84] These exceptions remain in the rule as modified by the proposed rule change.

Moreover, while the proposed rule change will not fully resolve the disparity that results from being subject to FINRA Rule 4210, when non-FINRA member banks are not, the proposed rule change to eliminate the maintenance margin requirement and the option to take a capital charge in lieu of margin should help to alleviate this disparity. The continued requirement to collect mark to market losses or take a capital charge in lieu of collecting margin will mitigate the risk that FINRA members will compete by implementing lower margin levels for Covered

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82 See FINRA Letter at 5-6.

83 See FINRA Letter at 6.

84 See 2016 Approval Order, 81 FR at 40375.

Agency Transactions and will help ensure that margin levels are set at sufficiently prudent levels across FINRA members.

The Commission agrees with FINRA that some comments have been previously addressed in the original rulemaking, including whether to impose any margin requirements on Covered Agency Transactions or exclude certain products from the scope of the rule, such as Specified Pools and CMOs.[85] These commenters provided comments about the rules that the Commission has previously approved, but those rules are not before the Commission in this filing.[86] As described above, the only amendments to the current rule before the Commission under the proposed rule change are to eliminate the maintenance margin requirement, permit capital in lieu of margin charges subject to a cap, and to reorganize and streamline the rule text. Because the margin requirements set forth in the original rulemaking were approved in the 2016 Approval Order, without this proposed rule change, the margin collection requirements in the original rule would become effective in 2022.

Further, the Commission agrees with FINRA that the regulatory need for attention to this area is no less than when FINRA initiated the original rulemaking. Recent events have reinforced the need to address unsecured exposures in the Covered Agency Transaction market, in view of its significance to the U.S. mortgage market and the financial system, more generally. Moreover, permitting counterparties to participate in the Covered Agency Transaction market without posting variation margin could facilitate increased leverage by customers, thereby posing a risk to the broker-dealer engaging in an unsecured transaction with a counterparty, and to the

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85 See, e.g., 2016 Approval Order, 81 FR at 40375-76 ("[E]xcluding additional products from the rule or modifying the settlement dates in the definition of Covered Agency Transactions potentially may "undermine the effectiveness of the proposal" if counterparties are permitted to maintain unsecured credit exposures on these positions").

86 See 2016 Approval Order.

marketplace as a whole. The imposition of margin requirements on Covered Agency Transactions also is consistent with other regulatory efforts that have sought to address the risk of uncollateralized exposures arising from different types of bilateral transactions with counterparties.[87]

Eliminating the two percent maintenance margin requirement will reduce operational burdens on FINRA member firms by eliminating the need to obtain and assess information regarding a counterparty's exempt or non-exempt status. Further, FINRA member firms will continue to be required to collect variation margin under the proposed rule change from a counterparty or take a capital charge, subject to a cap. This requirement will further the goal of reducing firm exposure to counterparty credit risk stemming from unsecured credit exposures in the Covered Agency Transaction market. The elimination of the two percent maintenance margin charge also reduces potential competitive disparities between FINRA broker-dealers and large bank dealers that are not subject to a maintenance margin requirement.[88]

The proposed rule change to permit FINRA members to take a capital charge in lieu of collecting margin, subject to a cap, will provide an alternative for firms that are concerned, due to their size, about facing competitive disadvantages. For example, to the extent smaller broker-dealers face difficulties obtaining margin agreements with counterparties, the capital charge provides an alternative. The capital in lieu of margin charges under the proposed rule change

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[87] See, e.g., Exchange Act Rule 18a-3 (imposing margin requirements on non-cleared security-based swap transactions for security-based swap dealers and major security-based swap participants).

[88] See Treasury Market Practices Group ("TMPG"), Margining in Agency MBS Trading (Nov. 2012), available at https:// www.newyorkfed.org/medialibrary/microsites/ tmpg/files/margining_tmpg_11142012.pdf ("TMPG Report"). The TMPG report recommends the exchange of variation margin for dealer banks. The TMPG is a group of market professionals that participate in the Covered Agency Transaction market and is sponsored by the Federal Reserve Bank of New York.

will require a broker-dealer to set aside net capital to address the risk of unsecured exposures in the Covered Agency Transaction market that can otherwise be mitigated through the collection of variation margin. The set aside of net capital will serve as an alternative to obtaining margin collateral for this purpose.

Additionally, the proposed caps and concentration limits on the proposed capital in lieu of margin charges will permit smaller broker-dealers to utilize the capital charge alternative, while limiting the amount of capital charges that large firms would be able to take under the proposed rule change. This will prohibit larger broker-dealers from using their size advantage (and larger capital base) to compete with smaller firms by using the capital charge in lieu of margin charge. Moreover, by providing the choice of either the collection of variation margin or a capital charge for the amount of the variation margin, the proposed rule change provides alternatives to broker-dealers with respect to their counterparties, while also protecting FINRA members from risks of unsecured credit exposures to Covered Agency Transactions.

Some commenters stated that a member with a Covered Agency Transaction position that is hedged from a market risk perspective, but is unhedged from a credit risk perspective, would have significantly higher capital charges or margin requirements under the proposed rule change than they would otherwise have absent the rule. The commenters described scenarios to illustrate this result.[89] FINRA stated that some of the scenarios involve firms that are fully hedged from a market risk perspective, like a firm that purchases a TBA, Specified Pool, or CMO from one party and enters into an offsetting sale transaction with another party, with the

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[89] See BDA Letter at 2-4; Brean Capital Letter at 15-18.

same settlement date. Commenters described these transactions as “riskless,” but FINRA stated that it disagrees with such characterization. FINRA stated that such a firm is exposed to the credit risk of both the buyer and seller, and the offsetting transactions provide no protection against those risks. FINRA stated that paragraph (e)(2)(H) of FINRA Rule 4210 requires members to protect themselves against that counterparty credit risk by collecting margin for their counterparties’ excess net mark to market losses or taking capital charges in lieu of such collection.[90]

According to FINRA, in some of these scenarios, commenters attributed the higher margin or capital requirements to the fact that the transactions (termed “non-netting” by one commenter and “non-nettable” by another) will not net under the proposed rule change. Under the proposed rule change, however, FINRA stated there is no category of transactions that cannot be netted in the determination of a counterparty’s “net mark to market loss.” According to FINRA, the only requirement is that the member have a legal right to offset losses on one transaction against gains on the other (or a security interest that would allow it to apply gains on one transaction to the counterparty’s losses on the other).[91]

FINRA stated that the “non-netting” or “non-nettable” transactions, as referenced by the commenters, appear to be transactions that are not eligible to be cleared by the Mortgage-Backed Securities Division of the Fixed Income Clearing Corporation (“MBSD”). However, FINRA stated that when an eligible transaction is submitted to the MBSD for clearing, that transaction is novated to the MBSD, so that instead of a transaction between the original buyer and seller, there are two mirror transactions: one in which the original buyer is buying from the MBSD; and one

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90 See Amendment No. 1 at 7.

91 See Amendment No. 1 at 7-8.

in which the original seller is selling to the MBSD. Accordingly, FINRA stated that when a firm executes with a single counterparty an MBSD-eligible transaction and a transaction that is not MBSD-eligible, and the eligible transaction is submitted for clearing (but the non-eligible transaction is not), the firm ends up with two transactions with two separate counterparties. These transactions cannot be netted against each other, according to FINRA, because they are with separate counterparties, rather than because of FINRA's proposed rule change, which in fact would allow gains and losses on the transactions to be netted to the extent of a perfected, first priority, security interest in the transaction with the gain.[92]

Further, according to FINRA, the current rule, as approved under the 2016 Approval Order, would, subject to specified exceptions, require members to collect margin whenever their counterparties' mark to market losses (and two percent maintenance margin deficiency, where applicable) exceeds $250,000, and would require them to take a capital charge to the extent such margin is not collected by the close of business on the business day after such mark to market loss (or maintenance margin deficiency) arose.[93] FINRA stated that the proposed rule change preserves all of the exceptions in the current rule, eliminates the two percent maintenance margin requirement, provides an option, subject to specified conditions, to take capital charges in lieu of collecting margin for net mark to market losses in excess of $250,000, and requires a capital charge to the extent margin for excess net mark to mark losses has not been collected by the close of business on the business day after such mark to market losses arose. Because the proposed rule change eliminates the two percent maintenance margin requirement (and as such eliminates the related capital charges for uncollected maintenance margin), FINRA stated that

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92 See Amendment No. 1 at 8.

93 See Amendment No. 1 at 8.

the margin requirements and capital charges under the proposed rule change are less than the requirements under the current rule.[94]

The Commission agrees with FINRA's analysis. The proposed rule change will reduce the current rule's requirements by permitting capital charges in lieu of margin and eliminating the two percent maintenance margin requirement. In addition, all of the exceptions in the current rule are preserved in the proposed rule change. Further, the proposed rule change allows a FINRA member to offset transactions where the member has a legal right to offset losses on one transaction against gains on the other. This permits a member the flexibility to net certain transactions, while protecting broker-dealers against counterparty credit risk by requiring them to collect margin for each counterparty's excess net mark to market losses or taking capital charges in lieu of such collection when transactions cannot be netted. Where transactions cannot be legally netted, the broker-dealer would be exposed to counterparty credit risk and, consequently, should collect variation margin from its counterparty or take a capital charge in lieu of collecting margin, unless an exception applies.

FINRA acknowledged that the margin requirements and capital charges under both the proposed rule change and the current rule are higher in certain scenarios (and lower in others) than they would be under a commenter's suggestion that (1) there should be no margin requirements applicable to Covered Agency Transactions (up to the second monthly SIFMA settlement date), and (2) members should be required to take capital charges for only ten percent of their counterparties' unmargined mark to market losses.[95] FINRA stated that it believes that

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94 See Amendment No. 1 at 8.

95 According to FINRA, under the current rule and the proposed rule change, members are not required to collect margin, or take capital charges in lieu of collecting margin, to cover the net mark to market losses of small cash counterparties, registered clearing

this suggestion would significantly undercut the objective of the rule.[96] FINRA also stated that a proposed alternative approach a commenter suggested that would not require margin to be posted until the next two "SIFMA good day settlements" and apply capital charges for 10 percent of the mark to market loss, instead of the 100 percent of the mark to market loss set forth in the proposed rule change, would significantly undercut the objective of the Covered Agency Transaction margin requirements.[97]

The Commission agrees with FINRA's analysis regarding the proposed capital charges or margin requirements. Reducing the proposed capital charges or margin requirements, or extending the time under which margin would not need to be collected until the next two good settlement dates would undermine the purposes of the rule to reduce the risk of unsecured exposures from Covered Agency Transactions. The proposed rule change will require a broker-dealer to collect variation margin from a customer or take a dollar-for-dollar capital charge for variation margin that is not collected from a counterparty, unless an exception applies. This requirement addresses the risk of a broker-dealer's unsecured exposures in the Covered Agency Transaction market that can be mitigated through the collection of variation margin or the set aside of net capital.

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agencies, Federal banking agencies (as defined in 12 U.S.C. 1813(z)), central banks, multinational central banks, foreign sovereigns, multilateral development banks, or the Bank forInternational Settlements. FINRA stated that these exceptions mean that some members engaging in Covered Agency Transactions with these counterparties may have lower margin and capital requirements under the current rule and the proposed rule change than they would under the commenter's suggestion. See Amendment No. 1 at 9.

[96] See Amendment No. 1 at 9.

[97] See Amendment No. 1 at 8-9.

Some commenters raised concerns that FINRA and the Commission lack the authority to prescribe margin requirements for Covered Agency Transactions.[98] The commenters argued that Section 7 of the Exchange Act identifies the Board of Governors of the Federal Reserve System ("Federal Reserve Board") as the entity responsible for regulating margin, and that Congress never intended the Commission to administer margin regimes.[99] Further, one commenter stated that Section 3(a)(12) of the Exchange Act defines Covered Agency Transactions as "exempted securities" and, therefore, not subject to the authority of the Federal Reserve Board or the Commission.[100] Another commenter stated that Senate Report in connection with the adoption of the Secondary Mortgage Market Enhancement Act of 1984 (including Section 7(g) of the Exchange Act) supports the view that the Federal Reserve Board has sole authority, and that Congress did not intend to grant FINRA authority to require margin for trades in exempt securities.[101]

FINRA addressed this assertion in the original rulemaking, and stated that the requirements are consistent with the provisions of Section 15A(b)(6) of the Securities Exchange Act.[102] FINRA stated that Section 7 of Securities Exchange Act sets forth the parameters of the margin setting authority of the Federal Reserve Board and does not bar action by FINRA.[103] The

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98 See Brean Capital Letter at 21-23; Melton Letter; BDA and Brean Capital Letter at 20-25. See also Boozman et al Letter at 2.

99 See Brean Capital Letter at 22-23; Melton Letter.

100 See Brean Capital Letter at 22.

101 See Melton Letter; BDA and Brean Capital Letter at 21-22.

102 See 2016 Approval Order, 81 FR at 40373.

103 See Amendment No. 1 at 7.

Commission agrees with FINRA that it is within FINRA's authority to impose margin requirements on its members.[104]

The Commission agrees with FINRA that the proposed rule change relating to streamlining and reorganizing the current rule enhances the transparency of the Covered Agency Transaction margin requirements. The consolidation of the rule text and deletion of unnecessary language may reduce costs and enhance efficiencies for broker-dealers, while preserving the exceptions in the current rule, such as the exception from collecting variation margin for net mark to market losses below $250,000 and the small cash counterparty exception. For example, the proposed rule change streamlines the language regarding the $250,000 exception making it easier to determine the applicable margin, which in turn, may reduce costs associated with calculating margin requirements when establishing trading relationships.

B. Other Comments, Clarifications; Technical Revisions to the Proposed Rule Change

In response to the Notice and the OIP, commenters raised additional issues regarding other aspects of the proposed rule change or requested clarifications or technical revisions to the proposed rule change. These comments are discussed in the following sections below.

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[104] See 12 CFR 220.1(b)(2) ("This [Regulation T]… does not preclude any exchange, national securities association, or creditor from imposing additional requirements or taking action for its own protection."); See also 2016 Approval Order, 81 FR at 40374 ("The stated goals of the proposal are consistent with the purposes of the Exchange Act and with FINRA's authority to impose margin requirements on its members."); paragraphs (e)(2)(A), (B), and (F) of FINRA Rule 4210 (imposing maintenance margin requirements on exempted securities, and requirements on transactions with exempt accounts involving certain good faith securities); and Federal Reserve Board Ruling (June 28, 1972), FRRS 5-622 ("Although the Board does not have authority to set margin requirements on exempted securities (FNMA stock is an exempted security), brokers and national securities exchanges can establish margin requirements more restrictive than those of the Board.").

1. Concerns Regarding Liquidation

Commenters expressed concern about requirements to liquidate Covered Agency Transactions stating that market participants often engage in long "chains" of Specified Pool or CMO transactions, where the initial seller contracts to sell a Specified Pool or CMO to the initial buyer, the initial buyer contracts to sell the Specified Pool or CMO to a second buyer, who contracts to sell it to a third buyer, who contracts to sell it to a fourth buyer, etc.[105] The commenters stated that if any party in the chain (except for the last buyer) terminates its purchase or sale transaction, the buyer in the terminated transaction is unlikely to be able to buy the Specified Pool or CMO elsewhere, and therefore will be unable to perform on its sale transaction – and so will every subsequent buyer and seller in the chain. These commenters stated that FINRA should eliminate or suspend the liquidation requirement under the proposed rule change to avoid the prospect of a "daisy chain" of fails.

FINRA responded that, under the current rule, if a counterparty's unmargined mark to market loss (and two percent maintenance margin deficiency, where applicable) exceeds $250,000 and is not margined or eliminated within five business days from the date it arises, the member is required to liquidate the counterparty's positions to satisfy the mark to market loss (and two percent maintenance margin deficiency where applicable), unless FINRA specifically grants additional time. FINRA also stated that the proposed rule change has eliminated this liquidation requirement.[106]

In addition, FINRA stated that, under the proposed rule change, a member can opt to take a capital charge in lieu of collecting margin to cover a counterparty's excess net mark to market

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105 See Brean Capital Letter at 12-13, 20; SIFMA Letter at 3.

106 See Amendment No. 1 at 9.

loss. FINRA stated that if these capital charges[107] exceed the lesser of 25 percent of the member's tentative net capital or $30 million[108] for five consecutive business days, then the member:

- May not enter into new Covered Agency Transactions with non-margin counterparties other than risk reducing transactions;
- Must, to the extent of its rights, promptly collect margin for each counterparty's excess net mark to market loss; and
- Must, to the extent of its rights, promptly liquidate the Covered Agency Transactions of any counterparty whose excess net mark to market loss is not margined or eliminated within five business days from the date it arises, unless FINRA has specifically granted the member additional time.[109]

Moreover, FINRA stated that if the member does not have the right to liquidate a counterparty's Covered Agency Transactions, the proposed rule change does not require the member to liquidate those transactions, even after the member has exceeded the threshold for five business days.[110] However, according to FINRA, if the member has exceeded the threshold

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[107] As discussed in more detail in Section II.C. above, FINRA stated that it is modifying the proposed rule change so that capital charges for a counterparty's unmargined excess net mark to market loss do not count toward this threshold to the extent that the member, in good faith, expects such excess net mark to market loss to be margined by the close of business on the fifth business day after it arose. See Amendment No. 1 at 10.

[108] Collectively referred to as the "25% TNC / $30MM Threshold".

[109] See Amendment No. 1 at 10.

[110] FINRA stated that a member is not required to have a right to liquidate a counterparty's Covered Agency Transactions. However, if the member does not have that right, the counterparty would be a "non-margin counterparty," and paragraph (e)(2)(H)(ii)d.1. under the proposed rule change would require the member to establish and enforce risk management procedures reasonably designed to ensure that the member would not exceed either of the limits specified in paragraph (e)(2)(I)(i) of the rule as amended by

for five business days and the member does have a right to liquidate a counterparty's Covered Agency Transactions and the counterparty's excess mark to market loss has not been margined or eliminated within five business days, only then would a member be required to enforce its liquidation right or obtain an extension from FINRA.[111]

The Commission agrees with FINRA that the changes described above provide for greater flexibility with respect to the liquidation requirement, and also provide an appropriate amount of time, via the ability take a capital charge in lieu of margin and to obtain an extension from FINRA, to permit firms to adequately address unmargined positions without requiring an immediate liquidation of positions. The proposed rule change eliminates the liquidation requirement under the current rule and replaces it with a requirement to liquidate a counterparty's Covered Agency Transactions in limited circumstances (e.g., only if the broker-dealer has a right to liquidate the transaction and only if certain conditions are met, including exceeding the specified cap on net capital deductions).

FINRA has also stated that this limited liquidation obligation should not lead to a daisy chain of fails, except possibly in circumstances where a counterparty's unwillingness or inability to perform its undisputed obligations makes it equally likely that a daisy chain or fails will occur whether or not the member liquidates a transaction with the counterparty.[112] According to

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the proposed rule change and that the member's capital charges in lieu of margin on Covered Agency Transactions for all accounts combined will not exceed $25 million. These procedures would likely involve limitations on the extent of the member's business with such non-margin counterparties. FINRA stated that when the firm's risk management procedures function as they are required to be designed, the member will rarely cross the 25% TNC / $30MM Threshold, much less exceed it for five consecutive business days. See Amendment No. 1 at 10.

111 See Amendment No. 1 at 10.

112 See Amendment No. 1 at 10-11.

FINRA, there are four categories of reasons why a counterparty would fail to margin its excess net mark to market loss by the fifth business day after it arises, and FINRA stated that it believes only one of them has any prospect of leading to a liquidation requirement under the proposed rule change:

- First Category – The counterparty may not have an obligation, under an agreement or otherwise, to margin its excess net mark to market losses within five business days after they arise. In this case, the member would not have a right to liquidate the counterparty's Covered Agency Transactions when excess net mark to market losses are not margined or eliminated within five business days after they arise, and so would have no obligation under the proposed rule change to liquidate the counterparty's Covered Agency Transactions.
- Second Category – An operational issue may cause the counterparty to fail to satisfy its obligation to margin its excess net mark to market losses. FINRA believes that five business days should be more than enough time to resolve any operational issue. However, in the event an extended operational issue, or series of operational issues, prevents a counterparty from providing margin for its excess net mark to market loss within five business days after it arises, a 14-day extension can be obtained from FINRA if the member has exceeded the 25% TNC / $30MM Threshold for five consecutive business days and would otherwise be under an obligation to enforce a right to liquidate the counterparty's Covered Agency Transactions. FINRA expects that an operational issue should not

continue long enough to prevent a counterparty from satisfying its margin obligation past the expiration of a 14-day extension.[113]

- Third Category - There may be a disagreement over the amount of the counterparty's excess markto market loss, leading the counterparty to believe that it has satisfied its obligation to provide margin but the firm to believe that it has not. Commenters suggested that relatively unique assets, like Specified Pools and CMOs, are more likely to be the subject of valuation disputes. FINRA stated that five business days should be more than enough time to resolve any valuation dispute. Firms whose business involves a significant volume of transactions that are prone to operational disputes should analyze whether their risk management procedures should require their contracts for such transactions to include or incorporate a procedure for the prompt resolution of valuation disputes.[114] FINRA stated that if an extended valuation dispute leads a counterparty to fail to provide margin for its excess net mark to market loss within five business days after it arises, a 14-day extension can be obtained from FINRA if the member has exceeded the 25% TNC / $30MM Threshold for five consecutive business days and would otherwise be under an obligation to enforce a right to liquidate the

[113] See Amendment No. 1 at 11.

[114] FINRA stated, by way of example, the current Credit Support Annex to the ISDA Master Agreement contains a provision under which the parties generally agree to resolve disputes over the valuation of over-the-counter derivatives for margin purposes by seeking four actual quotations at mid-market from third parties and taking the average of those obtained. FINRA stated that the OTC derivatives documented under ISDA Master Agreements can be much more difficult to value than any Specified Pool or CMO transaction. See Amendment No. 1 at 11-12.

counterparty's Covered Agency Transactions. FINRA stated that a margin valuation dispute should not continue past the expiration of a 14-day extension.

- Fourth Category - The counterparty may be unwilling or unable to satisfy an undisputed obligation to margin its excess net mark to market loss. FINRA believes that, when a counterparty is unwilling or unable to satisfy its undisputed margin obligations, there is also reason for significant doubt that the counterparty would be willing and able to satisfy its obligations to pay or deliver on the settlement date of the transaction. When facing such an unreliable counterparty, FINRA stated that it believes it is possible the daisy chain of fails may occur even if the member does not liquidate. FINRA further stated that this could be just as easily triggered by the counterparty's unwillingness or inability to perform its obligations as by the member's liquidation of its transaction.[115]

According to FINRA, with regard to this fourth category, to the extent feasible, members should terminate transactions with such counterparties in order to protect themselves against further exposure. However, FINRA stated that if a member believes that it would not be feasible to terminate a transaction with such a counterparty, or that such termination would be unduly disruptive to the member's business or the market, extensions may be available from FINRA if the member has exceeded the 25% TNC / $30MM Threshold for five consecutive business days and would otherwise be under an obligation to enforce a right to liquidate the counterparty's Covered Agency Transactions.[116]

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115 See Amendment No. 1 at 12.

116 FINRA stated that although an initial 14-day extension will be granted upon application citing the applicable circumstances, any application for a lengthy extension, or series of extensions, must describe the reason for the request and the member's plans for

According to FINRA, as described above, in the first category, members have no liquidation obligation under the proposed rule change. In the second and third categories, FINRA believes that the reason why the counterparty has not margined its excess net mark to market loss should be eliminated before the five business day period has ended, and generally before the expiration of a 14-day extension from FINRA. FINRA stated that only in the fourth category, where the counterparty is demonstrably unwilling or unable to perform its obligations to the member, should liquidation of counterparty's Covered Agency Transactions be required under the proposed rule change, provided that the member has exceeded the 25% TNC / $30MM Threshold for five consecutive business days – and, even in that case, extensions may be available if liquidation is infeasible or would unduly disrupt the member's business or the market.[117]

The Commission agrees that the responses provided by FINRA appropriately address the concerns raised by commenters concerning the potential for daisy chain fails. As described above, the requirement to liquidate a counterparty's position is limited under the proposed rule change to instances where the member has the right to liquidate a counterparty's Covered Agency Transactions. Otherwise, the proposed rule change does not require the member to liquidate those transactions where the member does not have a right to liquidate, even after the member has exceeded the 25% TNC / $30MM Threshold for five consecutive business days. Further, FINRA members may apply to FINRA to receive an extension of time beyond the five business day period. The ability to receive extensions of time beyond the five business day

protecting itself (now and in the future) against the risk posed by a counterparty that has demonstrated itself to be unwilling or unable to perform its undisputed obligations. See Amendment No. 1 at 12.

[117] See Amendment No. 1 at 12-13.

period will help to protect broker-dealers where liquidation is infeasible or would unduly disrupt the FINRA member's business or the market. Finally, in cases where a counterparty is unlikely or unwilling to satisfy a variation margin requirement, the broker-dealer's counterparty credit risk to its counterparty may increase, as well as the risk that the counterparty may be unable or unwilling to settle the transaction. In such cases, the likelihood of counterparty default may occur even if the broker-dealer does not liquidate the Covered Agency position or if it is not part of a chain of transactions.

2. Definition of "Excess Net Mark to Market Loss"

Some commenters requested confirmation that, under the proposed rule change, members would only be required to collect margin (or take capital charges for uncollected margin) to cover the amount by which a counterparty's net mark to market loss exceeds the $250,000 threshold.[118]

In response, FINRA stated that this is correct. According to FINRA, under the proposed rule change, paragraph (e)(2)(H)(ii)c. of FINRA Rule 4210 states that members are not required by the rule "to collect margin, or take capital charges, for counterparties' mark to market losses on Covered Agency Transactions other than excess net mark to market losses" and a counterparty's "excess net mark to market losses" are defined in paragraph (e)(2)(H)(i)c. as "such counterparty's net mark to market loss to the extent it exceeds $250,000."[119] FINRA stated that, for example, if a member's counterparty has a net mark to market loss of $300,000, its excess net mark to market loss is $50,000, which would be the amount of margin the proposed rule change would require the member to collect, or take a capital charge in lieu of

[118] See SIFMA Letter at 4; SIFMA AMG Letter at 4.

[119] See Amendment No. 1 at 13.

collecting (unless there is an applicable exemption). FINRA stated that the counterparty's excess net mark to market loss is the minimum amount of margin that (subject to the exceptions set forth in the proposed rule change) the member must collect (or take a capital charge in lieu of collecting). According to FINRA, the proposed rule change does not prevent members and their counterparties from agreeing that the counterparty will transfer additional margin. For example, FINRA stated that a member and its counterparty could agree that, when the counterparty's net mark to market loss exceeds $250,000, the counterparty will transfer to the member margin that covers the counterparty's entire mark to market loss, rather than only enough to cover its excess net mark to market loss. Similarly, FINRA stated that a member may exclude a counterparty's in the money amounts on long standby positions from its computation of net mark to market.[120]

FINRA's response appropriately responds to the commenters' request for confirmation by specifically confirming that under the proposed rule change members would only be required to collect margin to cover the amount by which a counterparty's net mark to market loss exceeds the $250,000. Also, FINRA's response is consistent with the definition of the term excess net mark to market losses under the proposed rule change.

3. Definition of "Net Mark to Market Loss"

A commenter requested confirmation that the definition of "net mark to market loss" would include the calculations used under the form of Master Securities Forward Transaction Agreement ("MSFTA") published by SIFMA.[121] In response, FINRA stated that it does not require or endorse any particular form of agreement for margining Covered Agency

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[120] See Amendment No. 1 at 13-14.

[121] See SIFMA Letter at 4.

Transactions, and as such declines to provide the requested confirmation, as this relates to what is a commercial matter among the parties.[122]

A commenter also suggested that FINRA should remove the phrase "legally enforceable right of offset or security" from the definition of "net mark to market loss."[123] In response, FINRA stated that this phrase is necessary.[124] According to FINRA, if the phrase is removed, then the amount of the counterparty's mark to market losses which are subject to margining would be reduced by the counterparty's mark to market gains on other transactions, without regard to whether the member has any legally enforceable right to apply those gains to cover the counterparty's losses. FINRA stated, for example, that if a counterparty defaults when it has a mark to market loss of $10 million on one transaction and a mark to market gain of $10 million on another transaction, having a legally enforceable right of offset would allow the member to apply the counterparty's gains to cover its losses. In the absence of a legally enforceable right of offset or security, however, FINRA stated that the member could face the prospect of having an obligation to pay the counterparty $10 million for its gains, without any guaranty of collecting the full amount of the counterparty's $10 million loss. According to FINRA, if the counterparty enters insolvency proceedings, the lack of a legally enforceable right of offset or security could

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122 See Amendment No. 1 at 14. Similarly, FINRA stated that it also declines a commenter's request to confirm that an MSFTA with a cure period (or similar provision after the expiration of which liquidating action may be taken) of less than or equal to five business days would provide the rights described in the definition of "non-margin counterparty" under paragraph (e)(2)(H)(i)e. under the proposed rule change. See Amendment No. 1 at 14 and SIFMA AMG Letter at 4.

123 See SIFMA Letter at 4.

124 See Amendment No. 1 at 14.

result in the member being obliged to pay the full $10 million of the defaulted counterparty's gains and being only able to collect cents on the dollar for the counterparty's losses.[125]

The Commission agrees that FINRA's response to the commenter's request for confirmation regarding the MSFTA as the proposed rule change does not require any particular form of agreement or contract. Further, the Commission agrees with FINRA that including the phrase "legally enforceable right of offset or security" in the definition of net mark to market loss is appropriate because it will allow a FINRA member to apply the counterparty's gains to cover its losses, which will reduce a broker-dealer's financial exposure to a counterparty in the event the counterparty enters insolvency.

4. Definition of "Non-Margin Counterparty"

With respect to the five business day period, paragraph (e)(2)(h)(i)e.1. under FINRA Rule 4210 under the proposed rule change provides in part that a counterparty is a non-margin counterparty if the member "does not have a right under a written agreement or otherwise to collect margin for such counterparty's excess net mark to market loss and to liquidate such counterparty's Covered Agency Transactions if any such excess net mark to market loss is not margined or eliminated within five business days from the date it arises."[126] A commenter stated

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125 See Amendment No. 1 at 14. In response to a commenter, FINRA stated that the phrase "first-priority perfected security interest" in paragraph (e)(2)(H)(i)d.2. under the proposed rule change only applies to pledges of a counterparty's rights under Covered Agency Transactions with third parties. See Amendment No. 1 at 14-15 and SIFMA Letter at 4.

126 In response to a commenter, FINRA stated that if a member has a right under a written agreement to collect margin for a counterparty's entire net mark to market loss whenever the amount of that loss exceeds $250,000. FINRA stated that, for purposes of the proposed rule change, it would view this as a right under a written agreement to collect margin for such counterparty's excess net mark to market loss, since the counterparty's excess net mark to market loss is $250,000 less than the counterparty's entire net mark to market loss (or zero if the net mark to market loss does not exceed $250,000). See Amendment No. 1 at 15 and SIFMA AMG Letter at 4.

that this effectively requires imposing a margin collection timing which is stricter than required under other rules or the standard under FINRA Rule 4210(f)(6).[127]

In response, FINRA stated that it disagrees for several reasons. First, FINRA stated that current rule requires members to liquidate positions whenever a mark to market loss (or maintenance deficiency) on Covered Agency Transactions is not margined or otherwise eliminated within five business days (and no extension has been obtained). According to FINRA, the proposed rule change uses a five business day period but, as discussed above, applies it more flexibly than the current rule.[128] FINRA stated that if the member lacks a right to liquidate a counterparty's Covered Agency Transactions if the counterparty's excess net mark to market loss is not margined or eliminated within five business days, that counterparty is a "non-margin counterparty." As consequence, the member would become subject to the risk management requirements under paragraph (e)(2)(H)(ii)d.2. of the rule as modified by the proposed rule change (if not already subject to that requirement); and if the member's specified net capital deductions[129] exceed the 25% TNC / $30MM Threshold for five consecutive business days, FINRA stated that the member would not be able to enter into transactions with the non-margin counterparty, other than risk reducing transactions, while those net capital deductions continue to exceed the 25% TNC / $30MM Threshold.[130] According to FINRA, if the member has a right to liquidate a counterparty's Covered Agency Transactions if the counterparty's excess net mark to market loss is not margined or eliminated within five business days, the member is not required to enforce that right (that is, not required to liquidate the counterparty's

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127 See SIFMA Letter at 4.

128 See Amendment No. 1 at 15.

129 See infra note 143.

130 See Amendment No. 1 at 16.

Covered Agency Transactions if the counterparty's excess net mark to market loss has not been margined or eliminated within five business days), unless and until the member's specified net capital deductions exceed the 25% TNC / $30MM Threshold for five consecutive business days (and the member has not obtained an extension from FINRA).[131]

Second, FINRA also stated that even if members were required to have a contractual right to liquidate when margin is not collected within five business days, that would not, in the commenter's terms, "impos[e] a margin collection timing that is stricter than that which is required under the rules (or other aspects of FINRA Rule 4210 generally)." Further, FINRA stated that FINRA Rule 4210(f)(6) requires margin to be collected "as promptly as possible," and the rule as approved pursuant to the original rulemaking (as stated above) requires liquidation when a mark to market or maintenance deficiency has not been margined or eliminated within five business days (unless an extension has been obtained).[132]

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131 See Amendment No. 1 at 16. In response to a commenter, FINRA stated that classification of a counterparty as a non-margin counterparty depends on (a) whether the member has the right to collect margin for the counterparty's excess net mark to market loss, (b) whether the member regularly collects margin for the counterparty's excess net mark to market loss, and (c) whether the member has the right to liquidate such counterparty's Covered Agency Transactions if the counterparty's excess net mark to market loss is not margined or eliminated within five business days from the date it arises. According to FINRA, classification of a counterparty as a margin counterparty (that is, as not a non-margin counterparty) does not require the member to exercise the right to liquidate whenever that counterparty's excess net mark to market loss is not margined or eliminate within five business days. However, FINRA stated that the counterparty would need to be reclassified as a non-margin counterparty if the member does not regularly collect margin for the counterparty's excess net mark to market loss. FINRA stated that the exercise of the right to liquidate is only required by the proposed rule change if the member's capital charges have exceeded the 25% TNC / $30MM Threshold for five consecutive business days (and the member has not obtained an extension from FINRA). See Amendment No. 1 at 16 and SIFMA Letter at 4-5.

132 See Amendment No. 1 at 16-17.

The Commission agrees with FINRA's response to a comment that the reference to a five business day requirement in the definition of non-margin counterparty effectively imposes a margin collection timing requirement that is stricter than under current rules. A counterparty is a non-margin counterparty under the proposed rule change if the broker-dealer does not have a right under a written agreement or otherwise to collect margin for such counterparty's excess net mark to market loss and to liquidate such counterparty's Covered Agency Transactions if any such excess net mark to market loss is not margined or eliminated within five business days from the date it arises. The five business day reference in the definition of non-margin counterparty is used to classify counterparties as non-margin counterparties and does not impose a five-day margin collection requirement.

Further, the current rule contains a liquidation requirement if a mark to market loss (or maintenance deficiency) on Covered Agency Transactions is not margined or otherwise eliminated within five business days (and no extension has been obtained). The proposed rule eliminates this requirement and provides for more flexibility with respect to whether a broker-dealer must liquidate a counterparty's positions if it has a right to do so, (i.e., only after certain conditions occur and only if no extensions of time have been granted). Therefore, the proposed rule changes does not effectively impose a margin collection or liquidation requirement whenever that counterparty's excess net mark to market loss is not margined or eliminated within five business days.

5. Exempted Counterparties

A commenter suggested that FINRA should explicitly exclude small cash counterparties and other counterparties covered by paragraph (e)(2)(H)(ii)a.1. under the proposed rule change

from the definition of "non-margin counterparty."[133] FINRA stated that this request is consistent with the purpose of paragraph (e)(2)(H)(ii)a.1. and has modified the definition of "non-margin counterparty" to implement the requested exclusion.[134]

Modifying the definition of "non-margin counterparty" is appropriate as it enhances transparency of the scope of the term to specifically exclude small cash counterparties.

6. Exemption for Certain Counterparties

A commenter suggested that the exceptions in paragraph (e)(2)(H)(ii)a.1. be expanded to encompass the U.S. Federal Home Loan Banks.[135] FINRA responded that it does not propose to make the suggested modification because it would undermine the rule's purpose of reducing risk.[136] The Commission agrees with FINRA's response regarding the expansion of the exceptions in paragraph (e)(2)(H)(ii)a.1., as including U.S. Federal Home Loan Banks in the exceptions would undermine the effectiveness of the proposed rule change, and would not be consistent with the purpose of the proposed rule change of reducing risk of unsecured exposures to Covered Agency Transactions.[137]

7. The 25% TNC / $30 MM Threshold

Regarding small cash counterparties, a commenter requested confirmation that margin not collected from small cash counterparties does not count toward the 25% TNC / $30MM

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133 See SIFMA Letter at 5.

134 See Amendment No. 1 at 17 and Exhibit 4 to Amendment No. 1.

135 See SIFMA Letter at 6.

136 See Amendment No. 1 at 17.

137 See also 2016 Approval Order, 81 FR at 40375-76 (discussion scope of exemptions under the current rule).

Threshold.[138] In response, FINRA stated that margin not collected from small cash counterparties does not count toward the 25% TNC / $30MM Threshold.[139] Further FINRA stated that paragraph (e)(2)(H)(ii)d.3. only counts capital charges under paragraph (e)(2)(H)(ii)d.1. toward the 25% TNC / $30MM Threshold. And, pursuant to paragraph (e)(2)(H)(ii)a.1., FINRA stated that members are not required under the proposed rule change "to collect margin, or to take capital charges in lieu of collecting such margin, for a counterparty's excess net mark to market loss if such counterparty is a small cash counterparty, registered clearing agency, Federal banking agency, as defined in 12 U.S.C. 1813(z), central bank, multinational central bank, foreign sovereign, multilateral development bank, or the Bank for International Settlements." FINRA stated that because the proposed rule change does not require members to take capital charges for these counterparties' unmargined excess net mark to market losses, they do not count toward the 25% TNC / $30MM Threshold.[140]

The Commission agrees with FINRA's response to the commenter's request for confirmation regarding whether margin not collected from small cash counterparties counts toward the 25% TNC / $30MM Threshold. FINRA's response appropriately addresses the commenter's concerns and is consistent with the purposes of the proposed rule change, because the proposed rule change also prescribes overall concentration thresholds under paragraph (e)(2)(I) of FINRA Rule 4210.[141]

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[138] See SIFMA Letter at 5.

[139] See Amendment No. 1 at 17.

[140] See Amendment No. 1 at 17.

[141] See Section II.B. above (discussing paragraph (e)(2)(I) of FINRA Rule 4210 under the proposed rule change).

With respect to counterparties yet to post margin, a commenter suggested that the proposed rule change be modified so that any capital charge under paragraph (e)(2)(H)(ii)d.1. of FINRA Rule 4210 not count toward the 25% TNC / $30MM Threshold until the fifth business day after the relevant excess net mark to market loss arose. The capital charge is required whenever a counterparty's excess net mark to market loss is not margined or eliminated by the close of business on the business day after the business day on which it arises. The commenter stated that many counterparties that are regularly margined are unable to post margin on a consistent T+1 basis due, for example, to those counterparties being in an overseas jurisdiction or to operational or custodial issues. Moreover, the commenter stated good faith disputes over the amount of margin to be posted may mean that a counterparty does not post margin by T+1 even when the counterparty is ready, willing, and able to post margin promptly after the proper amount is determined. Finally, the commenter stated that, without the grace period the commenter is requesting, members may be continuously over the 25% TNC / $30MM Threshold solely based on ordinary course levels of margin not yet collected from counterparties who are expected to post required margin.[142]

In response, FINRA stated that it agrees that the purpose of the proposed rule change does not require counting toward the 25% TNC / $30MM Threshold capital charges taken for excess net mark to market losses that the member in good faith expects to be margined by the fifth business day after they arise. Accordingly, FINRA revised paragraph (e)(2)(H)(ii)d.3. so that capital charges under paragraph (e)(2)(H)(ii)d.1. with respect to a counterparty's unmargined excess net mark to market loss do not count towards the thresholds in paragraph

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142 See SIFMA Letter at 5-6.

(e)(2)(H)(ii)d.3. to the extent that the member, in good faith, expects such unmargined excess net mark to market losses to be margined within five business days.[143] According to FINRA, members would still be required to protect themselves by taking net capital deductions while the excess net mark to market losses are unmargined, but, under the proposed rule change, as modified by Amendment No.1, will have more flexibility to address operational issues and valuation disputes before they impact the 25% TNC / $30MM Threshold.[144]

The proposed change related to the 25% TNC / $30 MM Threshold is appropriate as it provides additional time and flexibility for member firms to address operational and related issues related to the collection of margin, thereby avoiding unnecessary disruptions to the Covered Agency Transaction market. The proposed change related to the 25% TNC / $30 MM Threshold also enhances transparency with respect to the scope of transactions which count toward such threshold.

8. Requirement to Enforce Rights to Collect Margin and Liquidate Covered Agency Transactions

A commenter requested clarification with respect to the scope of the requirement under paragraph (e)(2)(H)(ii)d.3. of the proposed rule change, which provides that a member whose

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143 See Amendment No. 1 at 18. More specifically, FINRA has revised paragraph (e)(2)(H)(ii)d.3. of FINRA Rule 4210 to refer to a member's "specified net capital deductions" (rather than to all net capital deductions under paragraph (e)(2)(H)(ii)d.1.) and inserted the following definition into paragraph (e)(2)(H)(i): i. A member's "specified net capital deductions" are the net capital deductions required by paragraph (e)(2)(H)(ii)d.1. of this Rule with respect to all unmargined excess net mark to market losses of its counterparties, except to the extent that the member, in good faith, expects such excess net mark to market losses to be margined by the close of business on the fifth business day after they arose. Id.

144 See Amendment No. 1 at 18.

specified net capital deductions[145] exceed the 25% TNC / $30MM Threshold for five consecutive business days "shall also, to the extent of its rights, promptly collect margin for each counterparty's excess net mark to market loss and promptly liquidate the Covered Agency Transactions of any counterparty whose excess net mark to market loss is not margined or eliminated within five business days from the date it arises, unless FINRA has specifically granted the member additional time."[146]

According to FINRA, these requirements begin to apply once the member's specified net capital deductions exceed the 25% TNC / $30MM Threshold for five consecutive business days and cease to apply as soon as those capital charges fall below that threshold. Accordingly, FINRA stated, once the member's specified net capital deductions fall below that threshold (for example, because of market movements, or because the member collects enough margin from some, but not all, of its counterparties), the member is under no further obligation to enforce its contractual rights to collect margin or liquidate Covered Agency Transactions (and could, if it chooses, rescind outstanding margin calls and halt any liquidations of its counterparties' Covered Agency Transactions).[147]

FINRA's clarification relating to requirement to enforce rights to collect margin and liquidate Covered Agency Transactions appropriately addresses the commenter's request for clarification and enhances transparency with respect to the application of the proposed rule

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145 See supra note 143.

146 See SIFMA Letter at 5-6.

147 See Amendment No. 1 at 19. FINRA also stated that a member, so long as it acts promptly to bring itself below the 25% TNC / $30MM Threshold, may choose the manner and order in which it enforces its rights to collect margin or liquidate Covered Agency Transactions, and may halt those actions once its specified net capital deductions fall below the 25% TNC / $30MM Threshold. Id.

change as to when a FINRA member is under no further obligation to enforce its contractual rights to collect margin or liquidate positions.

9. Reporting by Members with Non-Margin Counterparties

FINRA stated that, pursuant to paragraph (e)(2)(H)(ii)d.4. under the proposed rule change, members with non-margin counterparties would be required to "submit to FINRA such information regarding its unmargined net mark to market losses, non-margin counterparties and related capital charges, in such form and manner, as FINRA shall prescribe by Regulatory Notice or similar communication." A commenter stated that the building of systems and information tracking is a significant build for many firms and requested FINRA to clarify in advance what information may be required.[148] FINRA stated that it is considering what information will be required to be submitted and expects to engage members and industry participants in developing appropriately tailored reporting pursuant to this provision.[149]

The Commission believes that FINRA's response is appropriate. FINRA is currently considering what information will be required and FINRA expects to engage with member firms and industry participants in developing tailored reporting requirements. This engagement will provide industry participants the opportunity to provide input into the reporting requirements.

10. Introducing and Clearing Firm Issues

A commenter stated said that the proposed rule change does not address the role of the clearing broker or reflect that FINRA has considered the actual way in which introducing brokers clear trades.[150] Another commenter suggested that FINRA should continue to facilitate dialogue

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148 See SIFMA Letter at 6.

149 See Amendment No. 1 at 19.

150 See Brean Capital Letter at 13.

among introducing and clearing firms to facilitate the implementation of the proposed rule change.[151]

FINRA responded by stating that it has conducted extensive dialogue with introducing and clearing firms regarding the requirements of the current rule and the proposed rule change in the context of introducing and clearing arrangements, and several of the proposed rule change's clarifying changes to the original rulemaking were informed by such dialogue.[152] Further, FINRA stated that it intends to continue to discuss the proposed rule change and its implementation with clearing and introducing firms, and to facilitate dialogue among them as the Covered Agency Transaction margin requirements are implemented.[153]

FINRA's response regarding issues involving clearing and introducing firms appropriately addresses the commenters' concerns. Specifically, FINRA has engaged in extensive dialogue with introducing and clearing firms regarding the requirements of the original rulemaking and with respect to the proposed rule change. Further, FINRA has indicated it will continue to facilitate dialogue with introducing and clearing firms as the margin requirements for Covered Agency Transactions are implemented.

11. Status of Published Frequently Asked Questions ("FAQs")

A commenter requested confirmation as to whether the FAQs regarding Covered Agency Transactions, maintained on FINRA's website,[154] will apply in the event the proposed rule

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151 See SIFMA Letter at 3.

152 See Amendment No. 1 at 20.

153 Id.

154 After the original rulemaking was approved, FINRA made available a set of FAQs and guidance clarify certain of the requirements, available at: www.finra.org.

change is approved.[155] FINRA stated that if the Commission approves the proposed rule change, FINRA will revisit the FAQs with Commission staff, members, and industry participants as appropriate.[156] The Commission agrees that FINRA's response to the status of the FAQs appropriately addresses the commenter's request for confirmation with respect to the application of the FAQs under the proposed rule change.

12. Implementation Period

In response to the proposed rule change, several commenters requested that FINRA provide an implementation period of at least 18 months after publication of a final rule text before compliance is required, stating that a constrained time period for implementation could present market access risk, and citing the need to build operations and technology and to negotiate necessary documentation.[157] FINRA responded to these concerns as part of Amendment No. 1 by stating while it believes that the subject matter is well understood by member firms and industry participants, FINRA would announce the effective date no later than 60 days following approval, if the Commission approves the proposed rule change, and would provide an effective date between nine and ten months following such approval.[158]

In response to Amendment No. 1, a commenter reiterated its previous comments regarding the implementation date, again requesting that FINRA provide an implementation period of 18 months, or in the alternative an implementation timeframe of at least one year.[159]

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[155] See SIFMA Letter at 6-7.

[156] See Amendment No. 1 at 20.

[157] See SIFMA AMG letter at 1-3; SIFMA Letter at 2; BDA Letter at 5.

[158] See Amendment No. 1 at 20.

[159] See Letter from Chris Killian, Managing Director, Securitization, Corporate Credit, Libor, Securities Industry and Financial Markets Association, to Secretary, Commission (Sep. 10, 2021). The comment letter was submitted jointly by SIFMA and SIFMA AMG.

FINRA responded to the comment stating that in connection with Amendment No. 1, it provided a longer implementation timeframe than originally proposed as part of the proposed rule change. FINRA stated that Covered Agency Transactions have been under discussion for a considerable time, both prior to and since approval of the original rulemaking in 2016, and that this subject matter is well understood by members and industry participants. As a result FINRA believes that the public interest would not be served by continuing delay and that the timeframe set forth in Amendment No. 1 is appropriate.[160]

FINRA's proposed implementation schedule is appropriate and consistent with the requirements of the Exchange Act. The Covered Agency Transaction margin requirements were approved in 2016 under the 2016 Approval Order. FINRA member firms and industry participants are aware of the requirements of the Covered Agency Transaction margin rule and have had time to work toward implementation. Consequently, the proposed implementation timeframe of nine to ten months from the approval date as described in Amendment No. 1 should provide sufficient time for FINRA firms to comply with the rule's requirements.

160 See FINRA Letter at 7-8.

IV. Conclusion

IT IS THEREFORE ORDERED pursuant to Section 19(b)(2) of the Exchange Act[161] that the proposed rule change (SR-FINRA-2021-010), as modified by Amendment No. 1, be, and hereby is, approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.[162]

J. Matthew DeLesDernier
Assistant Secretary

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161 15 U.S.C. 78s(b)(2).

162 17 CFR 200.30–3(a)(12).