March 27, 2014

Marcia E. Asquith
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, DC 20006

Subject: Comments of Institutional Investment Advisers on Proposed Amendments to FINRA Rule 4210

Dear Ms. Asquith:

The Association of Institutional INVESTORS (the "Association") appreciates the opportunity to submit the views of its members regarding FINRA's proposed amendments to FINRA Rule 4210 instituting more rigorous counterparty risk mitigation requirements applicable to broker-dealers participating in the TBA market (the "Proposed Amendments"). Such requirements would materially change how our member firms participate in the forward-settling Agency mortgage-backed securities markets ("Agency MBS"). As discussed below, the Proposed Amendments would also have a bearing on the investment activities of the customers of Association members. While we agree with FINRA's goal of mitigating systemic and counterparty risk, we are particularly mindful of the potential unintended consequences that may result from the Proposed Amendments.

The Association of Institutional INVESTORS is an organization of the oldest, largest, and most trusted federally registered investment advisers in the United States. Collectively, the Association's members manage investments for more than 80,000 ERISA pension plans, 401Ks, and mutual funds on behalf of more than 100 million American workers and retirees who rely on our firms to prudently manage participants' retirement savings and investments in part due to the fiduciary duty we owe these organizations and families. We recognize the significance of this role, and our comments are intended to reflect not just the concerns of the Association, but also the interests of the companies, labor unions, municipalities, families, and individuals we serve.

The Association supported the recent Agency MBS margining recommendation of the Treasury Market Practices Group ("TMPG"), which covers the same products and most of the same primary dealers that would be affected by the Proposed Amendments. Last year, the Association's Market Practices Council held dozens of meetings to promote educational awareness of the TMPG's Agency MBS margining initiative. These efforts assisted in furthering industry-wide adoption of Master Securities Forward Transaction Agreements ("MSFTA") by various market participants and the launch of customer outreach programs by client relationship teams at leading buy-side firms.

Our comments regarding the Proposed Amendments focus on the following topics:

1. Maintenance Margin Requirement;
2. Timeframes for the Collection of Margin and Required Liquidations;
3. Further Clarification of Collateral Requirements; and
4. Proposed Development Period and Implementation Period.

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1. **Maintenance Margin Requirement**

The Association opposes the requirement that 2% maintenance margin be collected from non-exempt accounts.

Under the Proposed Amendments, bilateral transactions in Covered Agency Securities would be marked to market daily and the member firm would be required to collect from its counterparty any mark to market loss on such transactions. In addition, if the counterparty is a non-exempt account, the member firm would be required to collect maintenance margin equal to two percent (2%) of the market value of the securities subject to the transaction. The Association believes that requiring non-exempt accounts to unilaterally deliver maintenance margin will: (i) have an adverse impact on Agency MBS market liquidity and lead to increased mortgage borrowing costs; (ii) expose non-exempt accounts to member firm counterparty risk and increase systemic risk; and (iii) provide incentive for non-exempt accounts to direct Agency MBS trading away from member firms.

The cost associated with requiring margin maintenance will fall disproportionately on non-exempt accounts because member firms are required to collect and not deliver maintenance margin. These costs are significant because they require accounts to pledge assets that otherwise could be used to generate returns for the account's beneficial owners. Moreover, the costs associated with building the legal and operational infrastructure necessary to track and safeguard pledged assets will be significant. As a result, non-exempt accounts will likely decide to exit the Agency MBS market, reduce Agency MBS trading, or shift their business to non-FINRA regulated banks. Fewer market participants will lead to reduced demand and a consolidation among larger institutions, which will result in reduced liquidity in the Agency MBS market. Reduced liquidity in the Agency MBS market (in particular, the TBA market) will cause a meaningful increase in hedging costs for mortgage originators, which may translate to higher borrowing costs for American homebuyers.

By posting maintenance margin, non-exempt accounts incur the risk that they may not be able to recover posted margin should the member firm default. As a result, requiring maintenance margin will expose non-exempt accounts to unsecured counterparty risk. Non-exempt accounts could partially address this risk by seeking member firm consent to deliver the maintenance margin to a segregated custodial account. However, this would introduce added cost primarily born by the non-exempt account. Furthermore, introducing additional counterparty risk into the Agency MBS market by requiring delivery of maintenance margin will have an incongruous impact because it creates, rather than diminishes, counterparty and systemic risk, which is the goal of both the FINRA Proposed Amendment and the TMPG margining recommendations.

Any significant lack of harmonization between the TMPG margining recommendations and the FINRA Proposed Amendments is likely to drive market participants away from member firms and to non-FINRA regulated banks. The TMPG margining recommendations require bilateral variation margining and do not require that member firms collect maintenance margin. Considering the risks, challenges, and costs associated with posting maintenance margin, non-exempt accounts are likely to be driven out of the Agency MBS market or forced to transact with banks operating under the TMPG margining recommendations. The resulting migration would take business away from member firms and consolidate trading with non-FINRA regulated banks. As mentioned above, the resulting market concentration will have an adverse impact on liquidity and could result in higher home financing costs.

2. **Timeframes for the Collection of Margin and Required Liquidation**

The Association believes that margin transfer timing should be left to the parties as a point of bilateral negotiation.

The Proposed Amendments state that "(t)he full amount of the sum of the required maintenance margin and any mark to market loss must be collected *when such sum* *exceeds the de minimis transfer amount*."[1] (emphasis added) This creates a requirement to effect immediate transfers or at least "same day" transfers of margin with respect to transactions in Covered Agency Securities.

The Association believes the actual timing of margin transfers should be left to the parties as a point of bilateral negotiation. Each market participant has its own internal credit and audit policies. In addition, most buy-side market participants (although not regulated by FINRA) are subject to their own regulatory or capital requirements that address the safety and soundness of their operations. We believe in light of these existing internal and external credit safeguards, the credit department of each party should have more flexibility when determining their delivery periods.

This flexible approach recognizes that each market participant presents their own unique credit profile and their counterparty may have a reasonable basis to afford each party different treatment with respect to this timing issue. Further, a market participant may want to avoid the obligation of same day transfers as a shorter timeframe creates greater operational burdens and for many market participants, still in the process of building collateral systems and infrastructure, the likelihood of failure is increased.

We recognize FINRA has an obvious interest in establishing rules that promote the safety and soundness of the entities subject to its jurisdiction. However, this needs to be balanced against the possible negative impact of such timing requirements on market participants, including those *not regulated* by FINRA. Therefore, the Association proposes that with respect to the required timing of margin, the Final Rule should establish that the maximum period allowed for the collection of margin should be no later than two (2) business days after timely written notice of such requirement to deliver margin.

The Association believes that transaction liquidation action should be at the discretion of the parties based on a number of relevant circumstances.

The Proposed Amendments state that if a "market loss is not satisfied within five business days from the date the loss was created, the member shall promptly take liquidating action, unless FINRA grants the member an extension of time."[2] The Association raises two concerns with the timing of this requirement to liquidate a transaction in Covered Agency Securities.

First, the Association believes that the suggested five day period is arbitrary. In two instances under Rule 4210, there is a five business day period within which certain margin obligations need to be satisfied.[3] However, in those instances the margin is related to transactions or arrangements where there is a direct extension of credit to a client's account. The margin obligations contemplated under the Proposed Amendments result

[1] Proposed §4210(e)(2)(H)(ii)(f)

[2] Proposed §4210(e)(2)(H)(ii)(d) & (e)

[3] *See e.g.* §4210(f)(8)(B)(iii)¶4 (RE: margin requirements for a day trading account) and §4210(f)(8)(B)(iv)d. (RE: special margin accounts for pattern trading account)

from change in market values of the underlying transaction or posted margin and should not be viewed as a direct extension of credit.

The Association makes the further observation that in an analogous situation, SIFMA's[4] "best practice" addressing when a buy-in should occur as the result of a failed delivery of securities on settlement date is *sixty (60) days*. Despite the failure of a seller to perform its delivery obligations, it is recognized that such failure is often the result of a corresponding delivery failure *to the seller* and not related to the creditworthiness of the seller. Notwithstanding that exposure could continue to accrue, the market practice is to extend two months to each party to resolve the failure. We believe these same market participants are able to determine the timing that is reasonable for a liquidation of a transaction caused by a failed margin delivery as the failure could be unrelated to the pledgor's credit but instead related to the pledgor's inability to settle a corresponding trade.

Second, the Association does not believe the Proposed Amendments sufficiently address the existence of good faith disputes with respect to the valuation of the forward settling Covered Agency Security or the value of previously posted margin. The rule should make some accommodation for the parties' ability to engage in such disputes and the Association imagines this could be structured in a way so as to avoid a material increase in counterparty risk (*e.g.* a dispute does not result in liquidation so long as there is a transfer of any undisputed amount).

In volatile markets, when pricing sources are not able to provide recent bid/ask pricing, there is greater likelihood for the parties to dispute the forward exposure created by a Covered Agency Security or the value of any posted margin. In addition, FINRA has provided that all Margin Equity Securities should be eligible collateral. It is anticipated that smaller, fixed income only market participants will have less familiarity with the equity markets and therefore the pricing of such equity securities potentially could also result in disputes.

Therefore, the Association believes the parties to a Covered Security Transaction should have more flexibility in determining what constitutes a technical default under the MFSTA and whether a liquidation or waiver and cure of such default or other workout is in the best interest of the parties. In addition, as the regulatory community is undoubtedly aware, the Association would like to mention that the industry has already begun executing the MFSTA to comply with the TPMG's recommended best practices for margining forward-settling securities. If market participants are required to implement the proposed FINRA requirements regarding required liquidation, it will result in substantial and costly renegotiation of completed MSFTAs.

[4] Through its predecessor, The Bond Market Association

3. **Further Clarification**

The Association seeks clarification from FINRA concerning certain items that relate to Minimum Transfer Amount and Eligible Collateral.

Minimum Transfer Amount

In the Proposed Amendments, it is stated, "Any aforementioned deficiency or mark to market losses with a single counterparty need not be collected if the aggregate amount of such deficiency or mark to market loss does not exceed $250,000 ("the de minimis transfer amount")…"[5]. The de minimis transfer amount is intended to strike a balance between ensuring a party is sufficiently collateralized given its overall exposure and avoiding small margin transfers that create excessive operational burdens and costs relative to the overall value of margin being transferred.

The Association would seek two clarifications on this point. First, we would ask that FINRA clarify that the de minimis transfer amount applies to *returns* as well as deliveries of collateral. As it is drafted now, the Proposed Amendments require that the de minimis transfer amount only applies to transfer of a "deficiency or mark to market loss" and is silent as to the amount that has to be returned (based upon changes in the mark to market loss) to a counterparty that has previously posted margin.

Second, the Association would ask FINRA to confirm that the parties are free to negotiate a de minimis transfer amount that is *less than* the $250,000 stated in the Proposed Amendments, as an amount that is more conservative than the de minimis transfer amount and, thus, would not frustrate the purposes of the Proposed Amendments.

Eligible Collateral

The Regulatory Notice describing the Proposed Amendments states that "…all margin eligible securities, with the appropriate margin requirement, should be permitted as collateral to satisfy required margin".[6] This would expand the current market convention of posting cash or U.S. Treasuries to include corporate and *equity securities*. Notwithstanding the inclusion of equity securities as eligible collateral in the Regulatory Notice, the Association would ask for clarification that the parties are free to negotiate any subset of eligible collateral that may exclude equities or any other security type.

There are several reasons why a party may wish to exclude equities or other collateral types from the eligible collateral agreed between the parties. First, as described above, smaller, fixed income only market participants may not have the familiarity or

[5] Proposed §4210(e)(2)(H)(ii)(f)

[6] Regulatory Notice 14-02 MARGIN REQUIREMENTS – FINRA Requests Comment on Proposed Amendment to the FINRA Rule 4210 for Transactions in the TBA Market

infrastructure necessary to price equities. As a result, holding equities as collateral creates its own systemic risks for market participants. Moreover, many of the third party pricing sources utilized for fixed income securities do not provide pricing for equity securities. Second, a market participant may be subject to a strict set of investment guidelines that does not allow the account to invest in or take possession of equities or other asset types. This could be the case, for example, with a registered mutual fund (whose investment mandate is set forth in its prospectus and SAI) or state regulated pension (which could be subject to state law enabling statutes).

4. Proposed Development Period and Implementation Period

The Association recommends that FINRA conduct further analysis of the impact of the Proposed Amendments.

The Association respectfully recommends that FINRA (perhaps in cooperation with the TMPG and an ad hoc group of buy and sell-side firms) continue to evaluate how best to harmonize their proposed margining rules with the TMPG's margining recommendation. The work to be conducted during this period (the "Development Period") would focus on achieving FINRA's aim of reducing systemic and counterparty risk while avoiding unintended disruption to the Agency MBS market. Other areas of focus could include whether the transaction netting and margining services of the Mortgage-backed Securities Clearing Corporation could be made available, either directly or indirectly, to institutional investment advisers. We also believe policy makers should consider establishing developmental plateaus (which would include regulatory guidance) to enable the major market participants to ultimately establish an updated Agency MBS trading and transaction processing model that simultaneously provides all participants in the marketplace with the most sophisticated and efficient forms of counterparty risk mitigation. To continue the steady progress toward margining Agency MBS and to avoid the risk of confusing buy-side firm clients while regulation is being deliberated, the Association expects that the TMPG margining recommendation will remain in effect during the proposed Development Period. Based on the evaluation performed during the Development Period, the Association believes that FINRA will develop a fuller understanding of the impact of Agency MBS margining and would be prepared to consider revisions to the Proposed Amendments.

The Association believes that an implementation period of eighteen to twenty-four months is appropriate.

Should FINRA decide to advance the rulemaking process without a Development Period, the Association believes that the Proposed Amendments should have an implementation period of eighteen to twenty-four months following the date of final SEC approval. This timeframe is necessary because each asset management firm will require considerable time to make operational, trading and legal agreement changes needed to comply with the Proposed Amendments. These changes could be extensive depending on the degree of harmonization between the Proposed Amendments and the TMPG's margining recommendation. For example, intense legal negotiations may be required and client outreach will be necessary to educate and seek client approval. Also, implementation will be delayed while firms seek appropriate regulatory input on interpretive matters until best practices ultimately evolve.

In conclusion, the members of our Association have been active participants in the Agency MBS markets on behalf of institutional investors since the inception of pass-through securities. As noted above, our Association has been responsive on substantive and educational matters regarding the recent recommendations of the TMPG to enhance risk mitigation practices with respect to forward-settling MBS transactions. We believe FINRA's Proposed Amendments to Rule 4210 have the potential to build upon the TMPG's recommendations. At the same time, as indicated in these comments, the Association believes that the Proposed Amendments may adversely impact the Agency MBS market. Please feel free to contact Joseph Sack, Staff Adviser to the Association, with any questions regarding this comment letter.
(joesack@sackconsulting.com / 914-648-0088).

On behalf of the Association of Institutional INVESTORS,

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President