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March 28, 2014

Marcia E. Asquith
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, DC 20006-1506

Comment Letter: FINRA proposed amendments to FINRA Rule 4210 to establish margin requirements for transactions in the To Be Announced (TBA) market

Dear Ms. Asquith:

I. Introduction and General Comment

We are grateful for this opportunity to submit this comment letter in respect of the above-mentioned proposed amendments to FINRA's Margin Rule 4210. Following consultation with a number of members of FINRA, Shearman & Sterling LLP respectfully submits this comment letter to FINRA regarding Regulatory Notice 14-02 that provides for a number of proposed amendments to FINRA Rule 4210 to establish margin requirements for transactions in the To Be Announced (TBA) market (the "Proposal").

1.1 General comment: the burdens of the Proposal, including burdens on competition, are significant, and need to be carefully assessed

In general, the FINRA member firms with whom we consulted support the underlying goal of the Proposal to reduce risk in the TBA market. However, the members believe that the Proposal will create higher costs of trading in TBA instruments, particularly for small accounts. The firms with whom we have consulted are concerned that the benefits of the Proposal are outweighed by costs that will be incurred as a result of the Proposal, and that the impact of the Proposal on competition, and the market generally, has not been considered in sufficient detail by FINRA. We, therefore, as a preliminary matter, recommend that the Proposal, when submitted to the Commission, contain a detailed evaluation and analysis of the costs and impact on competition of the Proposal, as well as a detailed discussion of the prospective negative impact of the Proposal on this market.

1.2 Outline

With that general comment said, our comments address six basic aspects of the Proposal: (i) the required amount of maintenance margin; (ii) the treatment of sub-accounts under the Proposal; (iii) the treatment of mortgage bankers under the Proposal; (iv) the definition of

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exempt accounts; (v) the capital deduction under the Proposal and (vi) the effects of posting margin away.

II. Substantive comments to the Proposal

2.1 The amount of maintenance margin to be posted by non-exempt accounts, if any, should be set by the member based on the member's risk assessment of the account.

The Proposal provides that for transactions with non-exempt accounts, members must collect maintenance margin equal to 2 percent of the market value of the securities.[1] As FINRA is aware, current industry practice is that members do not collect initial margin from counterparties. We believe that altering the market drastically, to now require a pre-determined amount of initial margin, will have negative unintended consequences. For example, the 2% margin requirement may be too great for some counterparties, forcing them to exit the TBA market or otherwise transact with market participants that are not subject to FINRA regulation. Further, due to the operational burden and counterparty risk issues associated with establishing a margin relationship, counterparties may naturally be reluctant to maintain the same number of broker relationships that they now enjoy. The result of a reduction in the number of brokers used by counterparties in this market will correspondingly be a reduction of the number of brokers in this market, and, as a result, a reduction in the competitiveness of the market.

It is our view that these consequences are appropriately mitigated by one of two approaches with the same end goal of providing flexibility as to the appropriate levels for initial margin as not to overly burden counterparties and drive them out of the market or force them to limit the number of trading relationships. One view is that members be allowed to set the amount of initial margin required of non-exempt accounts, if any, based on a risk assessment of such account. In this regard, we note that the Proposal requires members to make a determination in writing of a risk limit to be applied to each counterparty.[2] This requirement, will allow members to consider the risk associated with each non-exempt account and alter the amount of initial margin accordingly. Accordingly, we recommend that members be permitted to determine the amount of initial margin required of non-exempt accounts based on their risk analysis of such account.

Another view supported by the members we represent is that FINRA, together with the Commission, or acting in concert with Commission staff, set the maintenance margin percentage , however, on a more flexible basis. One way to do this would be to provide a sliding scale for the margin maintenance percentage more correlated to risk , to assist members in determining the appropriate amount of margin to be collected. This request is consistent with FINRA Rule 4210 as it exists today.[3]

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1 Proposed FINRA Rule 4210(e)(2)(H)(ii)(e).

2 See Proposed FINRA Rule 4210(H)(ii)(b).

3 See e.g., FINRA interpretive guidance found at Rule 4210(e)(2)(F)/04.

2.2 The treatment of Sub-Accounts under the Proposal should be consistent with existing FINRA and industry principles in respect of the recognition of Sub-Accounts.

The Proposal provides that "[f]or purposes of paragraph (e)(2)(H) of this Rule, the determination of whether an account qualifies as an exempt account[4] shall be made based upon the beneficial ownership of the account. Sub-accounts managed by an investment adviser, whereby the beneficial owner is other than the investment adviser, shall be margined individually."[5] When dealing with certain counterparties, members recognize the investment adviser as the counterparty, as opposed to the underlying sub-accounts, in accordance with FINRA principles.[6] We are of the view that members should be allowed to apply the margin requirements set forth in the Proposal at the level of the investment adviser, rather than separately to each sub-account. We are of this view for three reasons.

First, the recognition of a *bona fide* investment advisory arrangement by a broker-dealer is an ordinary-course, prudent and efficient means of conducting business as an intermediary. Absent identifying information of the kind discussed by FINRA in Regulatory Notice 10-18, a member firm usually finds that dealing with the investment adviser is sensible, efficient and prudent from a margin (and credit risk) perspective. Forcing members to separately evaluate the credit and client profiles of each Sub-Account will be both labor-intensive and inefficient, and is unlikely to give rise to additional conservatism on the part of broker-dealers.

Second, the proposal to separately margin each sub-account will require members to obtain new information regarding sub-accounts in order for the member to analyze whether the sub-account is an exempt account or not, to in turn allow the member to determine the appropriate margin requirements. For members that do not currently collect this information with respect to certain of their investment adviser counterparties' sub-accounts, requiring this

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4 An exempt account is defined under the FINRA rules as: "(A) a member, non-member broker-dealer registered as a broker or dealer under the Exchange Act, a "designated account," or (B) any person that: (i) has a net worth of at least $45 million and financial assets of at least $40 million . . . and (ii) either: a. has securities registered pursuant to Section 12 of the Exchange Act, has been subject to the reporting requirements of Section 13 of the Exchange Act for a period of at least 90 days and has filed all the reports required to be filed thereunder during the preceding 12 months (or such shorter period as it was required to file such reports), or b. has securities registered pursuant to the Securities Act, has been subject to the reporting requirements of Section 15(d) of the Exchange Act for a period of at least 90 days and has filed all the reports required to be filed thereunder during the preceding 12 months (or such shorter period as it was required to file such reports), or c. if such person is not subject to Section 13 or 15(d) of the Exchange Act, is a person with respect to which there is publicly available the information specified in paragraphs (a)(5)(i) through (xiv), inclusive, of SEA Rule 15c2-11, or d. furnishes information to the SEC as required by SEA Rule 12g3-2(b), or e. makes available to the member such current information regarding such person's ownership, business, operations and financial condition (including such person's current audited statement of financial condition, statement of income and statement of changes in stockholder's equity or comparable financial reports), as reasonably believed by the member to be accurate, sufficient for the purposes of performing a risk analysis in respect of such person."

5 Supplementary Material .04 of FINRA Rule 4210.

6 FINRA has summarized these principles on numerous occasions, including in Regulatory Notice 10-18 ("Master and Sub-Account Arrangements").

analysis will be onerous, and is likely to be resisted by investment advisers, who will have to furnish such information.[7]

Finally, the requirement to margin each Sub-Account individually would bring tremendous cost and inefficiency not only to the broker-dealer's compliance function, but also to the transaction process. Whereas a *bona fide* investment adviser arrangement currently permits the efficient addition of new Sub-Accounts to the trading process, the rule as proposed threatens to slow each new transaction as the parties determine the feasibility and substantive complete-ness of the proposed sub-accounting for each new transaction.

We respectfully request that the Proposal be amended to provide that where the member recognizes the investment adviser as its counterparty in accordance with FINRA principles, Sub-Accounts not be separately margined. Alternatively, we ask that FINRA substantially extend the implementation timeline to give members time to complete the time-consuming task of analyzing each Sub-Account for their purpose.

2.3 The treatment of Mortgage Bankers should recognize that information regarding the purpose of any specific counterparty's transactions is neither efficiently nor easily obtained, and would need to be frequently updated to recognize day-to-day change.

The Proposal provides that "[m]embers may treat mortgage bankers that use Covered Agency Securities to hedge their pipeline of mortgage commitments as exempt accounts for purposes of…this Rule."[8] (Emphasis added.) While we agree that mortgage bankers should be treated as exempt accounts, we respectively request that the condition that such mortgage banker must be hedging their pipeline of mortgage commitments be removed.

In short, we believe that knowledge and/or identification of this additional condition is unmanageable for FINRA members. Not only are the mortgage bankers' pipelines of mortgage commitments completely opaque to member firms, but such commitments are variable, changing intra-day based on factors such as the origination of new mortgages and the payment – or prepayment – of existing mortgages. Further, members are not in a good position either to diligence or to verify that specific transactions are intended to hedge mortgage commitments. Members, therefore, are not able to determine if the Covered Agency Securities[9] are being used for hedging purposes.

We also, again note that the Proposal requires that members make a determination in writing of a risk limit to be applied to each counterparty.[10] This requirement will allow members to

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[7] One member with which we discussed the Proposal reported that, at the instruction of *bona fide* investment adviser counterparties, they allocate transactions to approximately 8,000 Sub-Accounts, which would each need to be analyzed in order to comply with the proposed margin requirements.

[8] Proposed FINRA Rule 4210(e)(2)(H)(ii)(d).

[9] Capitalized terms used, but not defined here have the meanings ascribed to them in the Proposal.

[10] See Proposed FINRA Rule 4210(H)(ii)(b).

consider the risk associated with the mortgage banker's Covered Agency Securities and alter the applicable risk limits in accordance with such analysis. We, therefore, respectively request that members be permitted to treat mortgage bankers as exempt accounts with respect to all Covered Agency Securities.

2.4 The definition of exempt accounts should expressly include non-U.S. entities.

The current definition of exempt accounts only applies to U.S. based entities.[11] We ask that FINRA broaden this definition so it applies to both U.S. and non-U.S. entities that otherwise meet the definition. We believe that there is not a sufficient distinction between U.S. and non-U.S. financial industry participants to justify differential treatment under the FINRA rules.

To the extent FINRA is reluctant to expand the definition generally, then we recommend that the benefits a U.S. exempt account enjoys be expanded to like non-U.S. entities solely with respect to the Proposal. A limited expansion such as this would allow FINRA the opportunity to determine whether broader expansion of the definition is warranted, or whether such expansion poses presently-unidentified market risks.

2.5 The capital charge for uncollected margin below the minimum transfer amount should recognize members' credit risk evaluation and analysis.

The Proposal provides that "[a]ny 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 minimum transfer amount"), provided the member deducts such amount in computing net capital as provided in SEA Rule 15c3-1."[12]

Imposing a dollar-for-dollar deduction for deficiencies below the minimum transfer amount is insensitive to the counterparty risk analysis undertaken by members, and onerous from a capital perspective. We believe that the deduction should be required as a percentage of mark to market value of the subject securities and correlated to the probability of default. While some members we consulted believe that this risk analysis should be determined by the member in good faith on a counterparty basis, an alternate view put forth by other members is that FINRA provide the risk assessment model.

Under the first view, members would undertake a risk review of counterparties as required by the Proposal, which review would allow the member to determine the appropriate capital deduction, as well as to negotiate an appropriate minimum transfer amount.[13] Firms' good faith counterparty risk assessments, which FINRA will have the opportunity to guide and review, should likewise permit a corresponding good faith reduction in the required deduction.

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[11] See FINRA Rule 4210(a)(13).

[12] FINRA Rule 4210(H)(ii)(f).

[13] See Rule 4210(H)(ii)(b).

Accordingly, these members request that FINRA modify the Proposal to allow members to determine the appropriate capital deduction based on the member's risk analysis of the counterparties. In this respect, we also note that this recommendation is consistent with existing FINRA interpretive guidance found at Rule 4210(e)(2)(F)/04, which specifically addresses the importance of establishment of counterparty credit limits in this regard (and further provides additional guidance in respect of deductions from capital relating to the period to contract maturity), and is consistent with the prudent and robust counterparty risk assessment methodologies currently employed by the industry.

In the alternative view held by other members, consistent with this existing FINRA guidance and a more flexible and less onerous approach than imposition of regulatory capital on a dollar for dollar basis a standardized approach to a required regulatory capital deduction set by FINRA would be welcome. They recommend that FINRA implement a more detailed risk assessment model for members to use in determining the amount of the capital deduction. They note, however, that by requiring a dollar-for-dollar capital deduction, the draft proposal assumes a 100% probability of default, rather than utilizing market standard guidelines to determine this risk. If market standard risk based guidelines were applied, the result would be a much smaller probability of default and therefore, these members would suggest a lesser correlating percentage of regulatory capital be applied, not a dollar for dollar amount, but that these percentages be set by FINRA guidance. Further, we note that this approach would be consistent with the Basel III model.

2.6 The capital charge for uncollected margin should recognize members' credit risk evaluation and analysis in order to mitigate the effects of counterparties posting initial margin with third-party custodians.

Under the Proposal, counterparties are required to post initial margin to the member. In other markets, when posting initial margin, market participants from time to time request that instead of its broker-dealer counterparty holding any required initial margin, such participant be permitted to deposit the initial margin into an account with a third-party custodian that is pledged to the broker-dealer counterparty. While we acknowledge that there are benefits to such tri-party agreements, this arrangement would cause an undue burden on members. In implementing the tri-party arrangement, the member would in the usual course no longer be permitted to rehypothecate the initial margin collected from the counterparty. Therefore, if the member seeks to hedge a TBA transaction where the initial margin is being held by a third-party, the member will itself have to raise capital in order to post margin under the hedge transaction, instead of using the margin posted to it.[14] This will, undoubtedly, be a burden on all members, and a significant burden to competition that has not been evaluated.

Unfortunately, there are few good solutions to this problem. One way to mitigate this added burden, however, is by reducing the dollar-for-dollar deduction from capital for any

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[14] This is similar to the scenario where firms may need to post variation margin to a counterparty without the ability to collect from another counterparty when one side of their transaction is cleared through Mortgage-Backed Securities Clearing Corporation and the other side is bilateral. As FINRA acknowledges in this context, this could cause a significant liquidity strain on all members; we believe irrespective of their size.

deficiency or mark-to-market losses, and instead allowing members to determine the appropriate capital deduction below the minimum transfer amount based on its risk analysis of its counterparties, as discussed in Section 2.5 above.[15] We, therefore, respectfully request, again, that FINRA allow members to determine the appropriate capital deduction for deficiencies, including for deficiencies below the minimum transfer amount, based on their good faith risk analysis of their counterparties. Further, we believe that a member should not be disadvantaged from a capital perspective merely because it permit its counterparty to post collateral to a third-party bank. We are therefore of the view that the amount of collateral held by a third-party custodian and subject to a control agreement in favor of a member, should be permitted to be added to the member's net capital for purposes of computing the same in accordance with Rule 15c3-1. We recognize that such a rule would require consultation with the Commission, and encourage FINRA to make such consultations part of the rulemaking in this respect.

III. Conclusion

We thank you for considering these requests in connection with the Proposal and are, of course, very happy to discuss with you in greater detail any of our comments or requests. Please do not hesitate to contact the undersigned at russell.sacks@shearman.com or 212-848-7585 if you have any questions or require further information.

Sincerely,

Russell D. Sacks
Shearman & Sterling LLP

[15] See Proposed FINRA Rule 4210(H)(ii)(b).