O L S H A N

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September 10, 2021

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

Vanessa Countryman, Esq.
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Re: SR-FINRA-2021-010: 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

Dear Ms. Countryman:

We appreciate the Commission's determination to institute proceedings and the opportunity to provide comment on the proposed rule change of FINRA Rule 4210 (the "Proposed Rule Change") as modified by Amendment No. 1 ("Amendment No. 1"), which would establish margin requirements for Covered Agency Transactions ("CATs", defined below).[1] We write on behalf of the Bond Dealers of America, Inc. (the "BDA") and Brean Capital, LLC ("Brean"). The BDA, based in Washington, D.C., represents the interests of securities dealers and banks focused on the U.S. fixed income markets. Brean has considerable experience in the mortgage-backed security ("MBS") markets and, in particular, with CATs that are the subject of the Proposed Rule Change.

[1] *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 34-92713 (Aug. 20, 2021), 86 Fed. Reg. 47655 (Aug. 26, 2021) (hereinafter the "August Notice"); Notice of Filing of a Proposed Rule Change To Amend the Requirements for Covered Agency Transactions Under FINRA Rule 4210 (Margin Requirements) as Approved Pursuant to SR-FINRA-2015-036, Exchange Act Release 34-91937 (May 19, 2021), 86 Fed. Reg. 28161 (May 25, 2021) (hereinafter the "Notice"); Amendment No. 1 (Aug. 9, 2021) (https://www.sec.gov/comments/sr-finra-2021-010/srfinra2021010-9147461-247526.pdf). We understand that the Proposed Rule Change, inclusive of Amendment No. 1, would supersede SR-FINRA-2015-36, as approved on June 15, 2016, and amended thereafter.

Since 2014, when FINRA first contemplated taking the unprecedented action here under review, the BDA and Brean have alerted FINRA and Commission staff to FINRA's lack of statutory authority to enact this proposed rule, as well as to the harms that imposing margin requirements on CATs (commonly referred to as Agency MBS) will have on investors, on broker operations, on market liquidity, on competition, on mortgage financing and on the efficient operation of the securities markets. As promulgated, SR-FINRA-2015-36 will drive FINRA-member regional broker-dealers out of the Agency MBS market, harming the many state and local housing authorities and mortgage originators that rely upon these firms to access to the credit markets, which will in turn increase the cost of home financing. While FINRA has attempted to propose an alternative to mitigate SR-FINRA-2015-36's draconian impact, its proposed alternative falls far short, and these firms remain at risk of being driven out of the market. Due to our serious concerns and the many questions that remain unanswered by Amendment No. 1, we request the opportunity to make an oral presentation to the Commission.[2]

From the inception of CATs to the present, broker-dealer credit risk in this market has been successfully addressed through net capital requirements and underwriting practices. This remains true today. Indeed, FINRA has never made any showing that existing net capital requirements and underwriting practices do not adequately protect against the exact market risk that SR–FINRA–2015–036 purports to address. After seven years, the administrative record is devoid of evidence establishing the existence of the alleged credit problem the proposed rule seeks to resolve.

Imposition of mandatory margin requirements will have a demonstrable, negative effect on market liquidity, particularly on the liquidity that FINRA-registered regional broker-dealers provide to mortgage originators, institutional investors and the dealer community at large that are important participants in the Agency MBS market. SR-FINRA-2015-036 as adopted, although not yet

[2] *See* Rule 19b-4 under the Securities Exchange Act of 1934 (the "Exchange Act"), 17 C.F.R. 240.19b-4.

implemented, in fact exacerbates market risk and has already had a strong anti-competitive effect, providing a handful of primary dealers with disproportionate power to dictate terms and shifting business to non-FINRA bank dealers that are not subject to any margin regime. If implemented, SR-FINRA-2015-036 would diminish the role of regional broker-dealers in this important space or severely limit the business they can do in the ordinary course, because it will rapidly deplete the capital necessary to operate as a FINRA-member registered broker-dealer. SR-FINRA-2015-036 thus erects an impediment to a free and open market and to the equitable and efficient functioning of the national CAT market. This market is critical to cost-effective mortgage origination. SR-FINRA-2015-036, therefore, would ultimately result in higher costs to the American homebuyer. And, because the Proposed Rule Change would have the perverse result of shifting trading to less regulated markets, SR-FINRA-2015-036 will harm both investors and the public interest.

To its credit, FINRA has recognized the disruption to the market that SR-FINRA-2015-036 will cause. Beginning in November 2019, when it delayed implementation for the third time, FINRA acknowledged that it would consider amendments to SR-FINRA-2015-036 "in the interest of avoiding unnecessary disruption to the Covered Agency Transaction market."[3] Before the changes reflected in the Proposed Rule Change and Amendment No. 1, the margin requirements presented a serious threat to the CAT market. Investors informed dealers that they would not be willing to enter into margining agreements with many dealers, and investors were already starting to reduce the number of dealers with which they would trade CATs. Further, banks, who are not subject to the margining requirements, were using the imposition of margining on investors as a marketing opportunity to dissuade investors from trading with FINRA-regulated dealers at all. One such bank was even so bold as to produce a written marketing letter to that effect. Realizing the very real potential that the margining requirements

[3] Notice of Filing and Immediate Effectiveness of a Proposed Rule Change to Extend the Implementation Date of Certain Amendments to FINRA Rule 4210 Approved Pursuant to SR-FINRA-2015-036, Exchange Act Release 34-87441 (Nov. 1, 2019), 84 Fed. Reg. 60132 (Nov. 7, 2019).

would materially destabilize the CAT market, materially reduce liquidity in the market, and cause gross anti-competitive impacts, FINRA worked on the Proposed Rule Change and Amendment No. 1 to contemplate ways for dealers to take a capital charge in lieu of margin and other ways to avoid these major concerns. While FINRA intends for the Proposed Rule Change and Amendment No. 1 to minimize these harms, they in fact aggravate those harms for a substantial portion of the Agency MBS market.

Profound structural flaws make the architecture of the SR-FINRA-2015-036 and the Proposed Rule Change unworkable. Margin schemes presuppose a T+2 settlement date; they also presuppose that securities exist at the time the parties contract for purchase and are in the possession of the party receiving the credit. CATs, however, by design do not settle on T+2 in the normal course of business. Instead, most settle on a single, monthly *day* (otherwise known as a "good day") established by SIFMA. Oftentimes, the security (as, for example, a new issue Collateralized Mortgage Obligation, or "CMO") comes into existence immediately before settlement date. During the time between the trade date and settlement, "chains" of trades often develop. This raises a concern that FINRA's scheme may set in motion a chain of fails when a customer is unwilling or unable to post margin, as well as that the broker is unable to collect margin but there is no security to "liquidate." FINRA's response in Amendment No. 1 sidesteps these questions and ignores questions regarding how this rule will work in practice.

Nor has FINRA meaningfully addressed the drain on capital caused by its two-part "solution": (i) taking a charge to tentative net capital at 100% of the mark to market loss (defined as "specified net capital deductions")[4] when margin cannot be collected, and (ii) setting "the lesser of $30 million or 25% of a member's tentative net capital" as a threshold beyond which a FINRA member-dealer is prohibited from entering into new CATs with non-margin counterparties.[5] The underlying issue is that

[4] *See* Amendment No. 1 at 26 (Ex. 4, proposed Rule 4210(e)(H)(i)(i)).
[5] *Id.* at 30 (Ex. 4, proposed Rule 4210 (e)(H)(ii)(d)(3)). The threshold is referred to as the "25% TNC / $30MM Threshold" in Amendment No. 1. *Id*. at 10.

a meaningful portion of this market will not "net" under SR-FINRA-2015-036 and the Proposed Rule Change because of their unique characteristics. These include Specified Pools that do not clear through the Fixed Income Clearing Corporation ("FICC") and new issue CMOs. Both the BDA and Brean demonstrated in their comment letters on the Proposed Rule Change how, in the event of market movement, regional broker-dealers will be required to post cash margin and/or take the specified net capital deductions at a multiple of the regulatory net capital currently required to support the trade.[6] Charges may rapidly mount with a small number of trades. While the Proposed Rule Change therefore addresses in part the issue of customers that are unwilling or unable to post margin, as well as the lack of a mechanism that would enable an introducing broker to capture a customer's margin or to advance it to or among counterparties, it nevertheless creates an untenable alternative in which the regional broker-dealer's available capital will be rapidly depleted. This will sharply reduce the liquidity that these brokers provide to the CAT markets, make counterparties reluctant to do business with them, and will likely cause them to exit the market or to diminish their activities. These exits in turn will harm mortgage originators, institutional investors and the regional broker-dealers' other customers, because they tend not to have access to, or do business with, the primary dealers.

The core problems created by SR-FINRA-2015-036 are not remedied by the Proposed Rule Change, inclusive of Amendment No. 1. For this reason, the Proposed Rule Change should not be approved, and those portions of SR-FINRA-2015-036 that pertain to CATs should be repealed.

I. Factual Background

A. The Interest of the BDA and Brean in Covered Agency Transactions

The BDA is a Washington, D.C.-based trade association that exclusively represents securities dealers and banks whose primary focus is the U.S. fixed income markets. The BDA membership

[6] BDA Letter (June 15, 2021) (https://www.sec.gov/comments/sr-finra-2021-010/srfinra2021010-8922512-245116.pdf); Brean Letter (June 15, 2021) (https://www.sec.gov/comments/sr-finra-2021-010/srfinra2021010-8918033-245071.pdf).

includes over 70 firms headquartered nationwide and includes bulge bracket, middle market and regional dealers, both bank owned and independent and firms focused on retail as well as institutional fixed income, and minority, veteran and women-owned firms. The BDA promotes public policies and market practices that improve the market environment while also providing a forum for its members to debate and discuss issues of common interest. The BDA believes that by supporting the interests and prosperity of its members, it helps to strengthen the companies, municipalities and investors who depend on them for both access to market liquidity and to raise the capital needed to grow and prosper.

Brean's business is representative of other regional broker-dealers active in the CAT market. Its MBS & Rates division provides sales, trading, banking and advisory services on a wide range of mortgage and asset-backed securities, U.S. Treasury and Government Agency Securities, structured products such as CLOs, whole loans, and other securities. The division's trading volume is over $100 billion in securities annually, and Brean holds approximately $1 billion in inventory to facilitate customer liquidity. Brean provides more than 600 institutional investors, including mutual funds, pension funds, insurance companies, hedge funds, investment managers, and investment advisors, value-added investment ideas and access to execution services and inventory capital. To conduct these activities, Brean maintains substantial excess net capital.

Brean operates as an introducing broker. Brean, like 80% of its peers in this market, clears through Pershing, Inc. As part of that clearing relationship, Pershing holds substantial collateral, and extends credit to Brean. Pershing has the *contractual* right to collect margin from Brean on when-issued securities or new issue CMOs under certain market conditions. Pershing thus effectively underwrites much of the credit that Brean (and other introducing brokers) extend to their clients.

Brean understands that it may be exposed to risk if its counterparties, which primarily include broker-dealers, banks and other institutions, do not fulfill their obligations. Beyond regulatory requirements already in place,[7] Brean has strong incentive to review the creditworthiness of its counterparties. Accordingly, its policies require it to do so, just as Brean's counterparties review its creditworthiness before doing business with Brean. The same is true for all other market participants.

B. The Covered Agency Transaction Market

1. Participants

Most residential mortgages in the United States are securitized, with loans pooled into a separate legal trust, which issues the MBS and passes on mortgage payments to the MBS investors after deducting servicing fees and other expenses. In the Agency MBS market, each MBS carries a credit guarantee from Fannie Mae, Freddie Mac or Ginnie Mae. The market serves a critical function by allowing mortgage lenders to fund their origination pipelines and hedge the risk that interest rates may change. The market also creates efficiencies and cost savings for lenders that are passed on to homeowners in the form of lower rates. The Agency MBS market and the liquidity it provides are essential to the stability of the U.S. housing market.[8]

The Agency MBS market has operated with long settlement dates for more than three decades. Over time, a large liquid market has evolved. Data compiled by SIFMA indicates that in 2020, $3.7 trillion in Agency MBS were issued; in 2021 (through July), $2.5 trillion, and average daily trading volumes (as reported on TRACE) in 2020 were $262.3 billion for Agency TBAs, $25.7 billion for Specified Pools, and $1.8 billion for CMOs.[9] Market participants are almost exclusively institutional.

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[7] For example, the sole provision of SR-FINRA-2015-036 implemented to date requires that the broker-dealer make a risk limit determination for all counterparties to CATs. *See* FINRA Rule 4210(e)(2)(H)(ii)(b). This requirement is consistent with sound business practice.

[8] *See* James Vickery & Joshua Wright, TBA Trading and Liquidity in the Agency MBS Market, Federal Reserve Board of New York, Policy Review at 2-3 (May 2013) (https://www.newyorkfed.org/medialibrary/media/research/epr/2013/1212vick.pdf); *see also* James Collin Harkrader & Michael Puglia, Fixed Income Market Structure: Treasuries vs. Agency MBS, FEDS Notes (Aug. 25, 2020) (https://www.federalreserve.gov/econres/notes/feds-notes/fixed-income-market-structure-treasuries-vs-agency-mbs-20200825.htm).

[9] *See* data published at https://www.sifma.org/resources/research/us-mortgage-backed-securities-statistics/.

The market is characterized by more than 100 broker-dealers of varying sizes, who often buy and sell on a riskless basis or effectuate an offsetting trade within hours. Approximately 20 primary dealers operate in market-making and principal roles. Most primary dealers are major financial institutions and have bank affiliates. Studies by Federal Reserve Board ("FRB") economists have shown that the top 10 primary dealers intermediate the vast majority of CATs.[10]

Consistent with the market's desire to limit risk, the vast majority of broker-dealers in the CAT market are introducing brokers, trading through clearing firms. These broker-dealers play an important role in the secondary market, typically serving the role of liquidity provider by matching buyers and sellers of secondary, less liquid, non-FICC settling Specified Pools and new issue CMOs, currently using limited balance sheets in the process.[11] Many of the introducing firms are regional or smaller broker-dealers, and include minority, woman and veteran-owned firms. The clearing firms hold substantial collateral of introducing brokers and, as noted, a single firm, Pershing, clears for the majority of the introducing brokers. Some of the regional broker dealers have bank affiliates, a relationship which provides them with the ready ability to avoid Rule 4210.

Investors in CATs are a wide range of institutions, such as state and local pension plans, investment companies, investment funds, insurance companies, regional banks and mortgage originators. As is pertinent here, certain of these institutions, such as state pension funds, may be prohibited by their charters from pledging of pension assets, and therefore cannot post margin. Similarly, registered investment companies cannot re-pledge collateral. Many of these institutions

[10] Harkrader & Puglia, *supra* note 8. Data collected from April 1, 2019 to December 31, 2019 indicated that the top 10 dealers intermediated 87% of CATs trades through DTC. *Id.*

[11] Specified Pools and new issue CMOs are further described in Point I.B.2, below. In its June 15, 2021 comment, Brean characterized non-FICC settling Specified Pools and new issue CMOs as "non-netting." In Amendment No. 1, FINRA takes sharp issue with this use of the term "non-netting". Amendment No. 1 at 7-8, n.18. It is understood that for purposes of SR-FINRA-2015-36, positions will net when they settle with the same counterparty. For this reason, TBAs settling through FICC may "net". A purchase and sale of CATs that do not clear through FICC, or a hedging transaction in which only one side settles through FICC, do not net under the rule. By contrast, for purposes of the net capital rules, netting is considered on a balance sheet, or economic, basis. (*See*, Point IV, below.)

trade primarily through introducing brokers, in large part because smaller and medium-sized firms are best-suited to fill their needs. As a result the introducing brokers know their clients and client's risk profiles well, and vice-versa. The FRB is also a significant participant in the market.

2. Types of Covered Agency Transactions and Trading

SR-FINRA-2015-036 defines CATs as To-Be-Announced (TBA) transactions, Specified Pool Transactions, and Transactions in Collateralized Mortgage Obligations, or CMOs.[12]

The TBA market, which was established in the 1970s, is by far (90%) the largest segment of the CAT market. TBAs facilitate the forward trading of MBS issued by Fannie Mae and Freddie Mac, as well as Small Business Administration (SBA) backed Asset-Backed Securities (ABS). With TBAs, the parties agree that the seller will deliver to the buyer a pool or pools of a specified face amount and meeting certain other criteria but the specific pool or pools to be delivered at settlement is not specified at the time of execution.

The TBA market generally adheres to "Good Delivery Guidelines," which are posted in the Uniform Practices Manual maintained by SIFMA in consultation with its members and utilizes standardized trade documents developed by SIFMA.[13] These practices functionally standardize the market. TBAs have one good delivery and one settlement date per month (the "Good Day", depending on pool type). Specific pool information for the TBA is provided two days before settlement date.

Specified Pool Transactions are transactions in Agency MBS or SBA ABS requiring the delivery at settlement of a pool or pools that are identified by a unique pool identification number at the time of execution. The actual identities of bonds to be bought and sold are known at the time of the trade. Certain Specified Pools are deliverable into a TBA short, and will net for the purposes of the Proposed Rule Change. But many Specified Pools will not net under the Proposed Rule Change.

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[12] Amendment No. 1 at 21-22 (Ex. 4, proposed Rule 4210(e)(H)(i)(b)).
[13] *See* TBA MARKET FACT SHEET, SIFMA (2015) (https://www.sifma.org/wp-content/uploads/2011/03/SIFMA-TBA-Fact-Sheet.pdf).

These Specified Pools do not settle through FICC and generally do not meet the "Good Delivery Guidelines" to qualify as a TBA, in that the pools could be backed by high-balance mortgages, 40-year mortgages and adjustable-rate and interest-only mortgages. Non-FICC settling Specified Pools may be higher value than TBAs, in that they have the most advantageous prepayment characteristics, but lack the liquidity of the TBA market because they are not fungible.[14] Like TBAs, Specified Pools generally settle on a scheduled "good day," which is the same scheduled date as TBAs.

New issue CMOs subject to the Proposed Rule Change (i.e., not those CMOs that trade in secondary markets) are a type of securitized product backed by Agency pass-through MBS, mortgage loans, other types of MBS or assets derivative of MBS, that are structured in multiple classes of tranches with each class or tranche entitled to receive distributions of principal or interest according to the requirements adopted for the specific class or tranche. New issue CMO transactions generally settle on the last business day of the month.

Critical to understanding the impact of the Proposed Rule Change, most TBA trades are netable under the Proposed Rule Change and clear through FICC, and therefore will not result in a margin charge or increased net capital charge to regional broker-dealers. It is trading in *non-FICC settling* Specified Pools and new issue CMOs that will be most adversely affected by the Proposed Rule Change, because such trades, even in riskless transactions that have little or no economic or balance sheet impact, will not net for purposes of calculating margin obligations. Thus, while today, these trades may result in a 10% charge to net capital based on the mark to market loss, under the Proposed Rule Change, the same trades may result in both a net capital charge at 100% of the mark to market loss *and* a requirement to collect the same amount of margin. Amendment No. 1 does not change these requirements.

[14] *See* Vickery & Wright, *supra* note 8, at 5.

Each non-FICC settling Specified Pool and new issue CMO is unique, and, therefore, substitute securities may be impossible to locate. Ample price data, however, is available to market participants and regulators. Since May 2011, market participants that are members of FINRA have been required to report Agency MBS trades to FINRA's TRACE (Trade Reporting and Compliance Engine) system. (There is no comparable reporting for non-FINRA dealers.) After the close of each trading day, FINRA publicly reports summary statistics of daily trading volumes and prices. The trading itself occurs electronically on an over-the-counter basis, primarily through two platforms, DealerWeb (for inter-dealer trades) and TradeWeb (for customer trades).[15] Through these multiple data sources (including also, for example, Bloomberg), market participants obtain timely estimates of current market prices for TBA contracts.

A unique characteristic of the CAT market is that a single Specified Pool may be split or may have multiple buyers who then sell the securities in a chain of transactions, all settling on the "good day." In addition, broker-dealers, as well as originators, typically buy (or sell) a TBA security as a hedge against their trading of a non-FICC settling Specified Pool or new issue CMO. The premise of SR-FINRA-2015-036, as currently promulgated, and the Proposed Rule Change is that broker-dealers are subject to credit risk as the value of the MBS security fluctuates between trade date and settlement date.[16] In reality, their exposure is limited by hedging and offsetting trades, designed to lock in a modest profit (or loss) depending on the market's movement. This creates a "chain" of sales for these securities, offset with TBAs, illustrated by Figure A. The intermediary parties in the chain reduce their exposure with corresponding buys and sells. These chains develop over time, with downstream buyers purchasing closer to the settlement date and could well exceed the length in this example.

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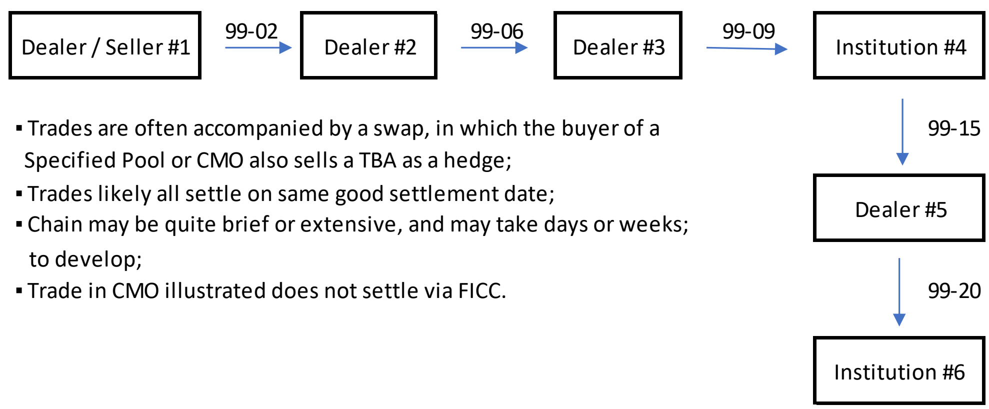
[15] Both platforms offer investors real-time estimates of the prices at which trades can be executed. FRB analysis shows that the quotes generally track prices of completed transactions closely. Vickery & Wright, *supra* note 8, at 9.
[16] Notice, 86 Fed. Reg. at 28162 and n.9.

Figure A - Prototype Trades in Covered Agency Transactions

Security: FNR 2021-42 NY 3136BGAM3 (CMO)
Trade Date: 06/01/2021
Settlement Date: 06/30/2021
Total Issuance size is 34,022,759
Trade Notional is 30,000,000

Assume the purchase and sale of $30mm FNR 2021-42 NY trades between counterparties at various prices as follows:



The chain of trades in the above Figure A also can be used to illustrate the impact of the Proposed Amendment and the FINRA Rule 4210. We assume that the chain occurs over a single trading day, leaving more than 20 days until settlement. In the interim, the market moves to the extent that margin must be posted by Dealer #2 and each other party in the chain. Under the current regime, each party's economic exposure is limited, since it has sold the bond, except for the end buyer, Institution #6. FINRA initially assumed that the end buyer would post collateral, and then that collateral could flow upstream to each of the parties in the chain. That assumption, as FINRA has acknowledged, is erroneous since many brokers are introducing brokers who cannot collect collateral and many institutions cannot or will not post collateral.

Assuming the Proposed Rule Change becomes effective, and there is an adverse market movement, the following might occur. Dealer/Seller #1 would demand and receive cash collateral from Dealer #2; Dealer #2 would also take a commensurate reduction to net capital when Dealer #3 can't post cash collateral; Dealer #3, however, would have to take a reduction to net capital, assuming

Institution #4 refused or was unable to post collateral; Institution #4 would do nothing since it is not governed by the rule; Dealer #5 would take a reduction to net capital, assuming Institution #6 would also be unwilling or unable to post collateral. For one trade, margin has been posted four times, on each occasion to the full mark to market loss, including by three parties who no longer have market risk because they have sold bond. The amount of margin collected bears no relation to the market risk presented and would drain significant capital from the broker dealers. This chain might be expanded to include many more parties, resulting in even more margin collected either through cash collateral or by a reduction to net capital.

C. FINRA's Protracted and Flawed Effort to Extend Rule 4210 to Covered Agency Transactions

Even in the most volatile months of 2008, the market for Agency MBS securities operated properly. While trading in non-agency MBS became illiquid, economists at the N.Y. Federal Reserve Bank (FRBNY) observed, "In contrast, issuance and trading volumes in the agency MBS market remained relatively robust throughout the crisis period."[17] The role of clearing brokers, the use of hedging, sound underwriting and the collateral maintained by broker-dealers all assured the ability of parties to honor their commitments on settlement date.[18]

In January 2014, FINRA initiated its effort to expand Rule 4210 to cover CAT transactions, stating that it was designed to reflect the growth of the TBA market and informed by the set of "best practices" adopted by the Treasury Market Practices Group (TMPG), a private sector group sponsored by the FRBNY.[19] As the rationale for the proposal, FINRA quoted the TPMG:

> To the extent that they remain unmargined, uncleared agency MBS transactions can pose significant counterparty risk to individual market participants. Moreover, the market's sheer size . . . raises systemic

[17] Vickery & Wright, *supra* note 8, at 3.
[18] *Id.*
[19] Margin Requirements: FINRA Requests Comment on Proposed Amendments to FINRA Rule 4210 for Transactions in the TBA Market, Regulatory Notice 14-02 (FINRA Jan. 2014) (https://www.finra.org/sites/default/files/NoticeDocument/p439087.pdf) (the "2014 Notice).

> concerns. If one or more market participants were to default on forward-settling agency MBS trades, the agency MBS market could transmit losses and risks to a broad array of other participants.[20]

FINRA also indicated a need for rulemaking because the TMPG's best practices were just that; "recommendations – they are not requirements."[21] Beyond quoting the TPMG, FINRA did not cite any data to support the existence of the stated market risk.[22] Of note, it remains the case today that TPMG's best practices pertaining to margining Agency MBS are only recommendations. No federal agency has issued rules to turn them into requirements.[23] Numerous market participants commented to FINRA, including the BDA and Brean.[24]

On October 6, 2015, FINRA filed its Notice to amend Rule 4210 with the Commission, soliciting comments.[25] In the 2015 Notice, FINRA relied upon its delegated authority under Section 15A(b)(6) of the Exchange Act to promulgate the rule change, claiming that it "will help to reduce the risk of loss in one of the largest fixed income markets and thereby help to protect investors and the public interest by ensuring orderly and stable markets."[26] FINRA did not analyze the SEC's authority to approve the amendment. The proposal continued the structure set forth in the 2014 Notice, while making two adjustments for smaller firms (and customers); a proposed $250,000 *de minimis* transfer amount and an exception where margin requirements would not apply if gross open CAT positions with a FINRA member were $2.5 million or less.[27]

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[20] *Id.* at 2-3 (quoting Report of the TMPG, Margining in Agency MBS Trading (Nov. 2012)).
[21] *Id.* at 3.
[22] *Id.*
[23] *See* TMPG Releases Updates to Agency MBS Margining Recommendation (TMPG Mar. 27, 2013) (https://www.newyorkfed.org/medialibrary/microsites/tmpg/files/Agency%20MBS%20margining%20public%20announcement%2003-27-2013.pdf.) No federal agency, including the FRB, has acted, because Congress has not empowered any federal agency to do so. *See, infra*, Point IV.A.
[24] BDA Letter (Mar. 28, 2014) (https://www.finra.org/sites/default/files/NoticeComment/p477637.pdf); Brean Letter (Mar. 21, 2014) (https://www.finra.org/sites/default/files/NoticeComment/p472296.pdf).
[25] Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of a Proposed Rule Change to Amend FINRA Rule 4210 (Margin Requirements) to Establish Margin Requirements for the TBA Market, Exchange Act Release 34-76148 (Oct. 14, 2015), 80 Fed. Reg. 63603 (Oct. 20, 2015) (the "2015 Notice").
[26] *Id.* at 63609.
[27] *Id.* at 63613.

A significant theme of the 2015 Notice was to conclude, based on an analysis of TRACE data on TBA trades (not, however, on Specified Pools or CMOs) between March 2012 and July 2013, that 85.7% of trades would fall within the $250,000 amount, and about half of all FINRA broker-dealers would not have to post mark to market margin under this exception.[28] FINRA then provided examples of ranges of margin (at that juncture, cash) that would have been posted based upon the analyzed data set.[29] While these amounts might in themselves have appeared manageable, they were disconnected from actual market functioning, in which a party must calculate in advance of a transaction counter-party risk and available cash to pay such margin. Again, numerous market participants commented, including the BDA and Brean.[30]

On June 15, 2016, after FINRA filed three amendments to the proposal, the Commission issued an Order approving SR-FINRA-2015-036, finding that the proposed rule change was consistent with Section 15A(b)(6) of the Exchange Act.[31] The final proposal raised the $2.5 million exception to $10 million, based on a data submitted by a clearing firm that showed that the exception would otherwise apply to a small number of accounts.[32] In its Order, the Commission credited comments regarding the considerable operational and systems work necessary to implement and maintain compliance with SR-FINRA-2015-036, stating that it believed that a 6-month time frame for the risk limit determination requirements and 18-months timeframe to implement the remainder of the rule "should provide sufficient time for FINRA firms to comply with the rule's requirements."[33]

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[28] *Id.* at 63612.
[29] *Id.* at 63613.
[30] *See* BDA letters dated Nov. 10, 2015, Feb. 11, 2016, May 2, 2016 and May 26, 2016, and Brean letters dated Nov. 10, 2015 and Apr. 27, 2016 posted at https://www.sec.gov/comments/sr-finra-2015-036/finra2015036.shtml.
[31] Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; 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, Exchange Act Release 34-78081 (Jun. 15, 2016), 81 Fed. Reg. 40364 at 40374 (Jun. 21, 2016).
[32] *Id.* at 40369.
[33] *Id.* at 40376.

As it turns out, the risk limit determination requirements are the only part of SR-FINRA-2015-036 that has ever been implemented. Due to continuing industry concerns and questions regarding the ability to implement SR-FINRA-2015-036, FINRA has repeatedly delayed the effective date. At the same time, FINRA-member regional broker-dealers continued to voice concerns to FINRA and the Commission Staff as to whether the rule was actually workable due to the anticipated drain on capital, as well as the many unanswered questions about how margin requirements would apply to chain trades and other transactions.[34] Finally, in November 2019, in delaying implementation for a third time, FINRA acknowledged that it would consider amendments to SR-FINRA-2015-036 due to concerns about the rule's impact on smaller and medium-sized firms and the market in general.[35]

With the onset of COVID-19, the Agency MBS market again faced a severe disruption. The issue, however, was unrelated to the "risk" sought to be addressed by SR-FINRA-2015-036 and the Proposed Rule Change. Chain trades did not fail. Instead, as economists at the NYFRB who studied the data observed, the disruption was the result of primary dealers reducing their activity (in part to protect their balance sheets), leading to a sharp reduction in liquidity in the market.[36] The FRB stepped in and provided liquidity to the primary dealers through purchases and hedging activity.[37] By contrast, it was the experience of BDA members that FINRA-member regional broker-dealers provided robust liquidity in terms of balance sheet and sales efforts. This is the *same* liquidity that will be drained by the adoption of the Proposed Rule Change. In short, March 2020 showed that SR-FINRA-2015-036, if implemented, (a) would not have addressed that market contraction, and (b) the liquidity shortfall would have been further aggravated without the participation of regional broker-dealers.

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[34] *See* Brean letters dated Jan. 9, 2018 and Nov. 11, 2017 posted at posted at https://www.sec.gov/comments/sr-finra-2015-036/finra2015036.shtml.
[35] 84 Fed. Reg. at 60133.
[36] *See* Jiakai Chen *et al.*, DEALERS AND THE DEALER OF LAST RESORT: EVIDENCE FROM MBS MARKETS IN THE COVID-19 CRISIS, Federal Reserve Board of New York, Staff Report No. 933 at 6 (Jul. 2020, rev. May 2021) (https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr933.pdf) ("Chen").
[37] *Id.*

On May 19, 2021, the Commission published the Notice regarding the Proposed Rule Change. In the Notice, FINRA noted that it was seeking to address concerns raised by its members regarding the impact of SR-FINRA-2015-036 on smaller firms compared to larger firms, and the ability of certain firms to shift business to non-FINRA member bank dealers, which would place member firms without such affiliates at a competitive disadvantage.[38] In an attempt to address these concerns, FINRA proposed three sets of revisions to SR-FINRA-2015-036: (1) to eliminate a 2% maintenance margin requirement; (2) to permit members under certain conditions to opt to take a capital charge in lieu of collecting margin for excess net mark to market losses on CATs; and (3) to clarify the language regarding the $250,000 *de minimis* transfer exception and the $10 million gross open position exception.[39] Critically, with respect to the alternative of permitting the capital charge, FINRA wrote:

> These conditions and limitations 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 in lieu of collecting margin to compete unfairly with smaller members.[40]

On June 15, 2020, the BDA and Brean submitted comments that focused on two main issues. First, the comments demonstrated through examples of the treatment of common trades (something missing from any of FINRA's notices) that the proposed alternative of net capital charges would rapidly deplete regional broker-dealers' capital, and therefore created untenable risk for counterparties seeking to do business with such firms, or would effectively put such firms out of business.[41] Such a result could not be justified in the name of alleviating the burden that SR-FINRA-2015-36 would place on these firms, particularly when one takes into account that these firms have long participated in the CAT market without any evidence of firm failure due to CAT trades or of their presenting systemic risk. Second and relatedly, SR-FINRA-2015-36 would remain unworkable. FINRA's plan to "monitor

[38] Notice, 86 Fed. Reg. at 28162.
[39] *Id.* at 28163.
[40] *Id*.
[41] BDA and Brean Letters, *see supra* n. 6.

the impact of the requirements pursuant to that rulemaking and, if the requirements prove overly onerous or otherwise are shown to negatively impact the market, . . . consider revisiting such requirements as may be necessary to mitigate the rule's impact" is simply not tenable.[42] By the time FINRA "revisits" requirements, regional broker dealers would likely have exited, be shut out of the business or failed. Indeed, this is why the Exchange Act requires the Commission to determine that a rule will not negatively impact the market *before* approving its adoption.

Amendment No. 1 does not address these concerns. Its sole substantive change is to remove the member firm's obligation to liquidate the counterparty's position.[43] As discussed more fully below, this proposal does not alleviate the solvency concerns raised in the BDA's and Brean's June 15, 2021 comments, because regional broker dealers will still face untenable net capital demands, and FINRA again has again failed to address critical questions regarding how this rule will work.

A key takeaway of Chen is that the liquidity provided by broker-dealers is critical to the Agency MBS market, which in turn provides crucial liquidity to the housing market.[44] This lesson did not appear to be absorbed by FINRA when it issued the Proposed Rule Change or Amendment No. 1. The Proposed Rule Change, as shown below, severely constricts the liquidity of introducing brokers whose role is key to the fluid operation of the Agency MBS market. In short, while FINRA has sought to solve for a theoretical problem, it has concretely increased the likelihood – by seeking to take action that will remove these broker-dealers from the market – that the next contraction in the Agency MBS market will be less manageable and concentrate further risk in the hands of a small number of banks.

II. The Standard of Review

FINRA is a registered securities association, and is therefore classified as a "self-regulatory organization."[45] Under the Exchange Act, the Commission is to approve a rule change proposed by a

[42] Notice, 86 Fed. Reg. at 28162.
[43] Amendment No. 1 at 9-10.
[44] Chen, *supra* note 36, at 4, 6.
[45] 15 U.S.C. § 78c(a)(26).

self-regulatory organization only "if it finds that such proposed rule change is consistent with" provisions of the Exchange Act.[46] "The Commission shall disapprove a proposed rule change of a self-regulatory organization if it does not make a finding" that the proposed rule change is consistent with the provisions of the Exchange Act.[47]

Section 15A(b)(6) of the Exchange Act provides that FINRA's rules must "promote just and equitable principles of trade," and "remove impediments to . . . a free and open market and a national market system," and "protect investors and the public interest."[48] The Commission must also ensure that FINRA's rules do not "permit unfair discrimination between customers, issuers, brokers, or dealers, to fix minimum profits, to impose any schedule or fix rates of commissions, allowances, discounts, or other fees to be charged by its members, or to regulate by virtue of any authority conferred by this chapter matters not related to the purposes of this chapter or the administration of the association."[49]

Section 15A(b)(9) addresses competition, requiring that "[t]he rules of [a registered securities association] do not impose any burden on competition not necessary or appropriate in furtherance of the purposes of" the 1934 Act.[50] As explained by the U.S. Court of Appeals for the D.C. Circuit, "The rules may not permit any unfair discrimination among customers, issuers, or dealers, nor impose any burden upon competition that is not necessary or appropriate in furtherance of the purposes of the Act."[51]

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[46] 15 U.S.C. § 78s(b)(2)(C)(i).
[47] 15 U.S.C. § 78s(b)(2)(C)(ii).
[48] 15 U.S.C. § 78o–3(b)(6).
[49] *Id.*
[50] 15 U.S.C. § 78o–3(b)(9).
[51] *Timpinaro v. S.E.C.*, 2 F.3d 453, 456 (D.C. Cir. 1993) (citing 15 U.S.C. § 78o–3(b)(9)); *see also* 15 U.S.C. § 78c-(f) ("Whenever pursuant to this chapter the Commission is engaged in rulemaking, or in the review of a rule of a self-regulatory organization, and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation").

The Commission may not abdicate responsibility to ensure that a propose rule is lawful to FINRA; it must affirmatively find and determine for itself, as it must in the case of every rule change proposed by a self-regulatory organization, that FINRA's proposed rule changes conform to the requirements of the Act.[52] "Nor may the SEC reach a conclusion [that a proposed rule change conforms to the Act] that is 'unsupported by substantial evidence' or 'arbitrary [and] capricious.'"[53]

III. The Commission and FINRA Lack Authority to Impose Margin on Covered Agency Transactions

A. <u>The SEC Lacks Rule Making Power to Impose Margin on Covered Agency Transactions under Section 7 of the Exchange Act</u>

"It is axiomatic that an administrative agency's power . . . is limited to the authority delegated by Congress."[54] Both the Proposed Rule Change and SR-FINRA-2015-036 are an effort by the Commission to regulate margin on CATs notwithstanding the lack of any authority to do so. The text of Section 7 of the Exchange Act identifies the FRB, and only the FRB, as the agency responsible for regulating margin.[55] The legislative history of Section 7 confirms that Congress never intended to confer authority on the Commission to establish a margin regime.[56] When Congress passed the Exchange Act, it acknowledged the FRB's "unique and outstanding expertise" in regulating credit.[57] Congress's "underlying theory of [the Exchange Act] with respect to the control of credit is … all speculative credit should be subjected to the central control of the Federal Reserve Board as the most experienced and best equipped credit agency of the Government."[58]

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[52] *See Susquehanna Int'l Group, LLP v. S.E.C.*, 866 F.3d 442, 446 (D.C. Cir. 2017); *Gerber v. Norton*, 294 F.3d 173, 185-86 (D.C. Cir. 2002); *Bradford Nat'l Clearing Corp. v. S.E.C.*, 590 F.2d 1085, 1113-14 (D.C. Cir. 1978).
[53] *Susquehanna,* 866 F.3d at 447 (quoting 5 U.S.C. § 706(2)(A), (E); 15 U.S.C. § 78y(a)(4)). *See also NetCoalition v. S.E.C.*, 615 F.3d 525, 537-44 (D.C. Cir. 2010) (vacating SEC order approving a self-regulatory organization's proposed rule change because of "lack of support in the record").
[54] *Bowen v. Georgetown Univ. Hosp.*, 488 U.S. 204, 208 (1988).
[55] 15 U.S.C. § 78g.
[56] *See* H.R. REP. NO. 73-1383, at 7 (1934) (delegating control of credit to the FRB).
[57] *Collateral Lenders Comm. v. Bd. of Governors of Fed. Res. Sys.*, 281 F. Supp. 899, 904 (S.D.N.Y. 1968); *see also* H.R. REP. NO. 98-994, at 48 (1984) (stating that the FRB "has primary rulemaking authority" with respect to margin, while the "Commission and the securities self-regulatory organizations enforce [the FRB's] rules").
[58] H.R. REP. NO. 73-1383, at 7 (1934).

The text of Section 7 also makes clear that CATs are "exempted securities" that fall outside the scope of the FRB's authority to set margin requirements. Section 7(c)(1)(A) of the Exchange Act provides:

> It shall be unlawful for any member of a national securities exchange or any broker or dealer, directly or indirectly, to extend or maintain credit or arrange for the extension or maintenance of credit to or for any customer— (A) on any security (other than an *exempted security*), except as provided in paragraph (2), in contravention of the rules and regulations which the Board of Governors of the Federal Reserve System (hereafter in this section referred to as the "Board") shall prescribe under subsections (a) and (b);….[59]

Section 3(a)(12) of the Exchange Act defines "exempted securities," to include "government securities" such as CATs.[60] Congress did not grant the FRB or the Commission authority to regulate "exempted securities."[61] Thus, Section 7 regulates "the amount of credit that may be initially extended and subsequently maintained on any security (*other than an exempted security* . . .)"[62]

In 1984, Congress adopted the Secondary Mortgage Market Enhancement Act (the "SMMEA"), to improve the marketability of private label mortgage-backed securities.[63] The SMMEA added new provisions to the Exchange Act, among other changes. To the definitions in Section 3(a) of the Exchange Act, the SMMEA added a new term, "mortgage related security" and to Section 7, it added a new subsection (g).[64] Alongside a notation "credit prohibition," the new provision stated:

> Subject to such rules and regulations as the Board of Governors of the Federal Reserve System may adopt in the public interest and for the protection of investors, no member of a national securities exchange or broker or dealer shall be deemed to have extended or maintained credit or arranged for the extension or maintenance of credit for the purpose of purchasing a security, within the meaning of this section, by reason

[59] 15 U.S.C. § 78g(c)(1)(A) (emphasis added).
[60] *See* 15 U.S.C. §§ 78c(a)(12)(A) ("[E]xempted securities" include "government securities"....) (internal quotation marks omitted); *id.* at § 78c(a)(42). FINRA adopted the same definition for FINRA Rule 4210(a)(6) from the legacy NASD margin rule, NASD Rule 2520(a)(6), as amended by SR-FINRA-2010-024 eff. Dec. 2, 2010 (The term "exempted security" or "exempted securities" has the meaning as in Section 3(a)(12) of the Act.").
[61] *See* 15 U.S.C. § 78g.
[62] 15 U.S.C. § 78g(a) (emphasis added).
[63] Pub. L. 98-440, 98 Stat. 1689.
[64] 15 U.S.C. §§ 78c(a)(41), 78g(g).

> of a bona fide agreement for delayed delivery of a mortgage related security against full payment of the purchase price thereof upon such delivery within one hundred and eighty days after the purchase, or within such shorter period as the Board of Governors of the Federal Reserve System may prescribe by rule or regulation.[65]

The 1984 amendments unequivocally prohibit the Commission from regulating credit extensions for private label MBS, provided a bona fide agreement for delivery of the security against full payment within 180 days of the purchase date was in force. In adopting this proscription, Congress recognized that CATs were already beyond the Commission's authority and wished to extend that exemption to their private label counterparts, with the FRB empowered to modify the time for delayed payments. The Senate Banking Committee's report on SMMEA articulated the legal and policy rationale for doing so, explicitly stating, "government-backed securities are exempt from these rules now."[66]

There is no basis to interpret "exempted securities" to include Agency MBS in some provisions of the Exchange Act, but not Section 7. Courts have long adhered to the "basic canon of statutory construction that identical terms within an Act bear the same meaning," or, stated differently, a word must share the same meaning throughout all provisions of a statute.[67] The Supreme Court has rejected "forced and unconventional" attempts to imbue a phrase used more than once in the same statute, with different meanings.[68] This canon of statutory construction applies all the more forcefully here, given that Congress has expressly instructed the Commission to ensure that any proposed rule changes be consistent with the provisions of the Exchange Act.[69]

The amendments to FINRA 4210 contravene this basic principle of statutory construction and Supreme Court precedent. The Exchange Act defines "exempted securities" to include CATs in

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[65] 15 U.S.C. § 78g(g).
[66] S. REP. NO. 98-293, at 8 (1983).
[67] *Est. of Cowart v. Nicklos Drilling Co*., 505 U.S. 469, 479 (1992).
[68] *Id*. at 478-79; *Goldstein v. S.E.C.*, 451 F.3d 873, 882 (D.C. Cir. 2006).
[69] 15 U.S.C. § 78s(b)(2)(C)(i).

Sections 3(a)(12). Rule 4210(a)(6) defines "exempted securities" the same way, adopting the meaning in § 3(a)(12) of the Exchange Act. But notwithstanding the Rule's definition of "exempted securities" to conform to Section 3(a)(12), the amendments to FINRA 4210 seek to regulate CATs —which, per their definition—are prohibited from credit regulation under Section 7.

Since it first proposed including CATs in Rule 4210, FINRA has never offered a legal rationale to support a departure from the decades-old regulatory regime wherein Agency MBS have not been subject to Section 7's margin requirements. "A statutory interpretation . . . that results from an unexplained departure from prior [agency] policy and practice is not a reasonable one."[70] FINRA's justification that "potential risk arising from unsecured credit exposures that exist in the Covered Agency Transaction market . . . could lead to financial losses by dealers" remains insufficient as a matter of law.[71] Even a perceived need for "more comprehensive regulation" does not entitle the Commission to re-write the text of the Exchange Act.[72]

B. <u>FINRA Lacks Rule Making Power to Impose Margin on Covered Agency Transactions under Section 15A(b)(6) of the Exchange Act</u>

FINRA has argued that even if the Commission lacks authority to regulate credit in CATs, FINRA has the authority to do so under Section 15A(b)(6) of the Exchange Act.[73] Again, under settled principles of statutory construction, the general authority granted to FINRA by Section 15A(b)(6) cannot be read to supersede the very specific statutory directives contained in Section 7 of the Exchange Act.[74] Such a sweeping grant of authority would render the limitations imposed by Section 7—and, for that matter, any limitations imposed by any section of the Exchange Act—superfluous, and would thus run afoul of "the basic interpretive canon that a 'statute should be construed [to give

[70] *See Northpoint Tech., Ltd. v. F.C.C.*, 412 F.3d 145, 156 (D.C. Cir. 2005).
[71] Notice, 86 Fed. Reg. at 28162.
[72] *Goldstein*, 451 F.3d at 882; *see also Util. Air Reg. Grp. v. E.P.A.*, 134 S. Ct. 2427, 2446 (2014) ("[A]n agency may not rewrite clear statutory terms to suit its own sense of how the statute should operate").
[73] Amendment No. 1 at 7 (citing 15 U.S.C. § 15A(b)(6)).
[74] *United States v. Chase*, 135 U.S. 255, 260 (1890); *Morales v. Trans World Airlines, Inc.*, 504 U.S. 374, 384 (1992) ("[I]t is a commonplace of statutory construction that the specific governs the general").

effect] to all its provisions, so that no part will be inoperative or superfluous, void or insignificant.'"[75] The grant of authority in Section 15A(b)(6), therefore, must be read in the context of the entire statute.[76] Subsection (6) provides the rules any association of brokers and dealers may "not [be] designed . . . to regulate by virtue of any authority conferred by this chapter matters not related to the purposes of this chapter or the administration of the association."[77] Subsection (2) likewise requires that any such association have "the capacity to be able to carry out the purposes of this chapter and to comply, . . . with the provisions of this chapter, the rules and regulations thereunder . . . ."[78]

Congress surely did not intend to prohibit even the FRB from regulating credit extensions for CATs, only to grant authority to a self-regulatory organization such as FINRA. Any such reading of Section 15A(b)(6) would frustrate, rather than "carry out the purposes of" the Exchange Act.

In addition, we do not believe that the text of Section 15A(b)(6) empowers FINRA to promulgate SR-FINRA-2015-036 or the Proposed Rule Change. Under Section 15A(b)(6), FINRA is empowered to promulgate rules to provide transparent and fair markets that are protective of investors. Section 15A(b)(6) predates the formation of FINRA by decades, when its purpose was to allow national securities associations to be formed and to promulgate rules that are designed to protect investors and other dealers in the trading of securities.[79] Here, by FINRA's own admission, the motivation underpinning SR-FINRA-2015-036 is to address a purported *systemic risk for the economy,*[80] which is outside of the purview of FINRA. In reality, this effort to impose a margin regime on the Agency MBS market treats the investor as the problem – not the protected party. It thereby

[75] *Genus Med. Tech. LLC v. United States Food and Drug Administration*, 994 F.3d 631, 638 (D.C. Cir. 2021) (quoting *Corley v. United States*, 556 U.S. 303, 314 (2009) (quoting *Hibbs v. Winn*, 542 U.S. 88, 101 (2004))) (alteration in original).
[76] *United States v. Morton*, 467 U.S. 822, 828 (1984) ("We do not . . . construe statutory phrases in isolation; we read statutes as a whole").
[77] 15 U.S.C. § 78o-3(b)(6).
[78] 15 U.S.C. § 78o-3(b)(2).
[79] 15 U.S.C. § 78o-3(b).
[80] *See,* 2015 Notice, 80 Fed. Reg. at 63604, 63610, 63613.

turns the purpose of Section 15A(b)(6) on its head. The notion that Congress could have intended for those associations to bite off macro-economic issues of systemic risk is absurd. Further, if Section 15A(b)(6) does allow FINRA to enter into a province customarily understood to belong to the FRB, what other elements of the economy not related to the transparent and fair trading of securities can FINRA regulate? We are not aware of any coherent legal analysis that explains how this decades-old authority could possibly allow FINRA to become the mini-FRB.

Moreover, FINRA is claiming the authority to re-define extension of credit in a manner never intended by Congress or publicly expressed by the FRB, defining all transactions in Agency MBS settling beyond T + 1 (T + 3 for CMOs) as an extension of credit. This represents a sea change in the regulatory regime related to transactions in those securities. A proposed rule that goes beyond the powers granted by the Exchange Act in order to accomplish an end that the Exchange Act prohibits cannot be said to be consistent with the provisions of the Act. Thus, while Section 15A(b)(6) may grant a national securities association broad powers, those powers must be limited by the authority of the agency that regulates FINRA and approves or disapproves its rules, *i.e.*, the Commission.

IV. The Amendments Are an Abuse of Discretion, in that They Are Unworkable, Increase Systemic Risk and Will Have a Catastrophic Effect on Regional Broker-Dealers and Remove Crucial Liquidity Needed by Customers from the Agency MBS Market

A. <u>FINRA Has Not Contested the BDA's and Brean's Demonstration that the Proposed Rule Change Will Deplete Regional Broker Dealers' Capital, thereby Harming Customers</u>

A key feature of the BDA's and Brean's analysis of the Proposed Rule Change was their examination of how the option to take a net capital charge (effectively a requirement, since there is no mechanism for introducing brokers to collect cash collateral on most CATs) will, in a matter of a few typical trades, force regional broker dealers out of this market. In response, FINRA has not questioned the math. Instead, in Amendment No. 1, FINRA has largely side-stepped the problem, by taking issue with Brean's characterization of the illustrative transactions as "riskless" and commenting that such transactions are not riskless from a legal perspective.[81] FINRA also implies that the 25% TNC / $30MM Threshold is sufficiently high to avoid draconian consequences, noting 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."[82] Unsurprisingly, no data or analysis of likely trades supports FINRA's claim of rarity, or that the 25% TNC / $30MM Threshold will not have a dramatic effect on liquidity.

(1) How Typical Trades Will Deplete Capital

Examining a few typical trades booked for good day settlement between Brean and a primary dealer illustrates the adverse effects that the Proposed Rule Change will have. **Illustration 1** shows the impact that the Proposed Rule Change will have if Brean buys a non-FICC settling Specified Pool and sells a TBA to that same primary dealer that does net FICC. The purchase of the Specified Pool is fully hedged. Brean buys $100 million of a non-FICC settling Specified Pool of Ginnie Maes from a primary dealer, and sells $100 million of TBAs back to the same primary dealer to hedge the exposure. This is a typical buy with an off-setting position. After the trade date, the market decreases by 3 points. Brean takes a $3 million mark to market loss on the non-FICC settling Specified Pool, which is offset by the mark to market gain on the hedge.

Under current FINRA rules, Brean would take a $300,000 charge to its regulatory capital for the mark to market loss on the non-FICC settling Specified Pool. This treatment – which captures the risk – has been in place for decades. However, for purposes of SR-FINRA-2015-36, for the first time, the buy will be treated as independent of the TBA sale, because while the TBA settles via FICC, the primary dealer is the counterparty on the non-FICC settling Specified Pool for settlement purposes

[81] *See, e.g.,* Amendment No. 1 at 7-8, n.18.
[82] *See, id.* at 10, n.21.

(FICC, not the primary, is the counterparty on the TBA).[83] Illustration 1 shows that because broker-dealers will be required to post margin for "each counterparty's excess *net* mark to market loss,"[84] this fully hedged trade will result in a $3,000,000 margin call:

Illustration 1: Financial and regulatory impact of 4210										
	Current					*Proposed 4210*				
	Cash	Margin @ Pershing	WI Req @ Pershing	Reg Capital	TOTAL	Cash	Margin @ Pershing	WI Req @ Pershing	Reg Capital	TOTAL
MTM	-	-	-	(300,000) *	(300,000)	-	-	-	-	-
Margin Call	-	-	-	-	-	(3,000,000) **	-	-	-	(3,000,000)
TOTAL	-	-	-	(300,000)	**(300,000)**	(3,000,000)	-	-	-	**(3,000,000)**

Transaction Description		
T/D	S/D	
6/1/2021	6/21/2021	Brean Capital ***BUYS*** $100mm of Ginnie Mae II Pool (G2 MA7359 (36179WE87) - ***NON FICC SETTLING / NON DELIVERABLE*** for their inventory from a primary dealer
6/1/2021	6/21/2021	Brean Capital ***SELLS*** $100mm of TBA back to the primary (G2SF 2 1/2 Jun21 (21H022663) - ***FICC SETTLING / DELIVERABLE*** to hedge their exposure to the pool **** Brean Capital is facing different counterparties on each of these transactions***

Subsequent Event and Impact to Brean Capital	
Event	**- After trade date and before settlement date the value of the pool purchased by Brean decreased by 3 points or $3mm dollars.**
Current Impact	**- From an equity perspective the mark to market loss of $3mm on the long pool purchased would be offset by a $3mm mark to market gain on the hedge position.** *** - Brean would incur a $300k regulatory capital charge due to the decrease in market value of the pool purchased (10% x $3,000,000)**
Proposed Impact	**** - Brean is issued a margin call for $3mm from the seller of the pool due to the fact that the pool is NON FICC SETTLING / NON DELIVERABLE in essence a bilateral transaction & therefore must wire $3mm to the seller of the pool to satisfy the call. Additionally, due to the fact that Brean is not a member of the MBSCC it is unable to recover from the net any of the margin it was required to post.** **- By satisfying the margin call to the seller of the pool the regulatory capital charge of $300k would be eliminated.**
Summary	**- Even though Brean Capital has effectively hedged its exposure by selling a TBA of the same size, under Rule 4210 it would be required to post margin to the seller of the NON FICC SETTLING / NON DELIVERABLE pool. Currently the impact of this transaction to Brean would be a $300k regulatory charge whereas under the proposed rule 4210 it would be required to post $3mm in margin, or an increase of $2.7mm.**

Illustration 2 shows another typical trade that is riskless for computations of net capital and the credit line with the clearing firm. In this illustration, Brean buys $100 million of a non-FICC settling Specified Pool of Ginnie Maes from a primary dealer, and sells $100 million of the *same* Specified Pool of Ginnie Maes to a customer. Again, after trade date, the market decreases by 3 points.

Under current FINRA rules, Brean would take a $300,000 charge to its regulatory capital for the mark to market loss on the non-FICC settling Specified Pool it purchased. However, under the

[83] It is for this reason that Brean and other industry participants have repeatedly urged in prior comment letters that FICC increase its capacity to clear such Specified Pools and new issue CMOs so that trades like Illustration 1 settle with a single counterparty, FICC. We respectfully submit that the Commission appoint an industry task force to address this issue.
[84] Notice, 86 Fed. Reg. at 28163-64 (emphasis added.)

Proposed Rule Change, Brean will be issued a $3,000,000 margin call by the seller of the pool it purchased and must wire cash to that party. Under the Proposed Rule Change, Brean would now also be required to collect $3,000,000 in margin from its customer due to the mark to market loss in the customer's Specified Pool. Brean, however, could not do so, however, because it either does not have or cannot have a margin agreement with the customer. Brean would now be required to take an additional $3,000,000 regulatory capital charge:

Illustration 2: Financial and regulatory impact of 4210

	Current					Proposed 4210				
	Cash	Margin @ Pershing	WI Req @ Pershing	Reg Capital	TOTAL	Cash	Margin @ Pershing	WI Req @ Pershing	Reg Capital	TOTAL
MTM	-	-	-	(300,000) *	(300,000)	-	-	-	-	-
Margin Call	-	-	-	-	-	(3,000,000) **	-	-	(3,000,000) ***	(6,000,000)
TOTAL	-	-	-	(300,000)	**(300,000)**	(3,000,000)	-	-	(3,000,000)	**(6,000,000)**

Transaction Description

T/D	S/D	
6/1/2021	6/21/2021	Brean Capital ***BUYS*** $100mm of Ginnie Mae II Pool (G2 MA7185 (36179V6W5) - ***NON FICC SETTLING / NON DELIVERABLE*** for their inventory from a primary dealer
6/1/2021	6/21/2021	Brean Capital ***SELLS*** $100mm of the same Ginnie Mae II Pool (G2 MA7185 (36179V6W5) - ***NON FICC SETTLING / NON DELIVERABLE*** from their inventory to a customer
		**** In principle this is a riskless trade from the Brean perspective.***

Subsequent Event and Impact to Brean Capital

Event	- After trade date and before settlement date the value of the pool purchased by Brean decreased by 3 points or $3mm dollars.
Current Impact	- From an equity perspective the mark to market loss of $3mm on the pool purchased would be offset by a $3mm mark to market gain on the sale of the same pool. * - Brean would incur a $300k regulatory capital charge due to the decrease in market value of the pool purchased (10% x $3,000,000)
Proposed Impact	** - Brean is issued a margin call for $3mm from the seller of the pool due to the fact that the pool is NON FICC SETTLING / NON DELIVERABLE in essence a bilateral transaction & therefore must wire $3mm to the seller of the pool to satisfy the call. However, Brean is unable to issue a call to the buyer of the same pool due to a variety of reasons and therefore must take the full regulatory capital charge of $3mm. - By satisfying the margin call to the seller of the pool the regulatory capital charge of $300k would be eliminated.
Summary	- Even though Brean Capital has entered into a riskless principal trade under the proposed rule 4210 they would be required to post margin to the seller & take a regulatory capital charge for the amount that they are unable to call from their customer. The impact to Brean currently is a $300k regulatory charge whereas under rule 4210 total impact would be $6.0mm or an increase of 1900%.

Of note, in this example, it would make no difference under the Proposed Rule Change that the customer might have posted $3,000,000 in margin with the clearing broker; Brean would still have to post $3,000,000 to the primary dealer of its own cash. That is because it is not clear if Brean has the contractual right to collect the margin and there does not appear to be a mechanism in place today for Brean to collect it.

Separate from, and in addition to regulatory requirements, all introducing brokers are subject to contractual margin requirements imposed by their clearing firms. FINRA does not appear to have considered the economic burden of the Proposed Rule Change when added to the clearing firm's requirements. **Illustration 3** shows that impact on the broker's liquidity of another normal trade. In Illustration 3, the broker makes three trades: a sale of $100 million of a netting Ginnie Mae pool to a primary dealer, a purchase of $100 of new issue CMOs from the primary dealer made up of the same Ginnie Mae pool and a sale of the new issue CMO to its customer. Again, after trade date, the market decreases by 3 points before settlement date.

Under current FINRA rules, Brean would take a $300,000 charge to its regulatory capital for the mark to market loss on the new issue CMO it purchased and incur a 1½% charge to its clearing firm (against the collateral held by the clearing firm) under the contractual margin arrangement applicable to when-issued securities. Under the Proposed Rule Change, in addition to the 1½% charge to its clearing firm, Brean would take a $3,000,000 charge to net capital and, because the customer cannot legally margin, Brean would also be required to post $3,000,000 to the primary dealer on behalf of the customer as a result of the CMO falling three points on price.

Illustration 3: Financial and regulatory impact of 4210										
	Current					*Proposed 4210*				
	Cash	Margin @ Pershing	WI Req @ Pershing	Reg Capital	TOTAL	Cash	Margin @ Pershing	WI Req @ Pershing	Reg Capital	TOTAL
MTM	-	-	(1,500,000) ****	(300,000) *	(1,800,000)	-	(1,500,000)	-	-	(1,500,000)
Margin Call	-	-	-	-	-	(3,000,000) **	-	-	(3,000,000) ***	(6,000,000)
TOTAL	-	-	(1,500,000)	(300,000)	**(1,800,000)**	(3,000,000)	(1,500,000)	-	(3,000,000)	**(7,500,000)**

Transaction Description		
T/D	**S/D**	
6/1/2021	6/21/2021	Brean Capital ***SELLS*** $100mm of Ginnie Mae II Pool (G2 MA7311 (36179WDQ8) - ***FICC SETTLING* / DELIVERABLE** to a primary dealer from Inventory
6/1/2021	6/30/2021	Brean Capital ***BUYS*** $100mm of New Issue CMO from the primary dealer which was created from the collateral sold, Ginnie Mae II Pool (G2 MA 7311 (36179WDQ8))
6/1/2021	6/30/2021	Brean Capital ***SELLS*** $100m of the same New Issue CMO (Collateral sold to the primary dealer) to Institutional a/c that cannot or will not post collateral to Brean
		**** The trades above are in agreement with the SIFMA settlement schedule (good day settlement)***
		***** As a result the agency pools sold to the primary dealer netted in FICC, and FICC credits Pershing not Brean Capital, in this example $3mm***

Subsequent Event and Impact to Brean Capital	
Event	**- After trade date and before settlement date the value of the CMO purchased from the primary dealer decreased by 3 points or $3mm dollars.**
Current Impact	*** - Brean would incur a $300k regulatory capital charge due to the decrease in market value of the CMO purchased (10% x $3,000,000)**
	****** - Brean is required to post margin to Pershing in the amount of 1.5% of future settling when issued securities (notional) 1.5% x $100mm.**
Proposed Impact	**** - Brean is issued a margin call for $3mm from the seller of the CMO to cover the decrease in value so Brean has to wire $3mm in cash to satisfy the call as it cannot use the corresponding decrease in the value of the collateral sold to offset the call because Brean does not have access to the net.**
	***** Given the fact that Brean is unable to collect margin from the buyer of the CMO it is required to take a regulatory capital charge for the full amount of the call, in this case $3mm. Additionally, since Brean does not have access to the net it must use it's own cash to satisfy the call.**
	****** - Brean is still required to post margin to Pershing in the amount of 1.5% of when issued securities (notional) 1.5% x $100mm.**
	- By satisfying the margin call to the seller of the CMO the regulatory capital charge of $300k would be eliminated.
Summary	**- SIFMA requires that all CMO securitizations be created in accordance with their settlement calendar known as "good day settlement." In this example Brean would be required to post margin to the seller & take a regulatory capital charge for the amount that they are unable to call from their customer. Under current rules the impact to Brean would be $1.8mm whereas under 4210 total impact would be $7.5mm.**

The illustrations look at trades in isolation. In the real world, dealers do not handle one trade per month; they service multiple customers. This magnifies the potential of the Proposed Rule Change to use a substantial portion of FINRA broker-dealers' available capital and to restrict their other business activities.

(2) <u>Amendment No. 1 Does Not Reasonably Address the Problem of Capital Depletion</u>

As noted above, FINRA takes issue with the trade illustrations on the grounds that the trades depicted are not actually "riskless."[85] FINRA's response, however, misses the point. Such trades are, today, structured to be "riskless" from an economic and net capital perspective. Moreover, FINRA ignores the significant measures that have been taken by participants in the Agency MBS market to address risk. For example, FINRA members already engage in in-depth, quarterly underwriting of

[85] *See, supra,* n.11; *see also* Amendment No. 1 at 7-8.

their counterparties. While the implementation of SR-FINRA-2015-036's risk limit determination requirements formalized such measures, member firms participating in this market already, and necessarily engaged in this practice, as have the institutional investors active in this market. Simply stated, counterparties cannot afford to risk failed trades. In the millions of Agency MBS trades effected by Brean's trading desk (including at predecessor firms), the desk has never had a failed CAT trade.

For introducing brokers, a second layer of underwriting exists: the underwriting conducted by their clearing firm. In the illustrations above, the clearing firm has made a determination from a balance sheet perspective that the trades are "riskless," or fully hedged, and pairs the buy and sell transactions. When the introducing broker has made such trades, the clearing firm does not treat them as if it has extended credit to the introducing broker.

Of course, the member firm already takes regulatory capital charge of 10% whenever there is a mark to market variance, and such charges are currently considered when counterparties evaluate the financial wherewithal of FINRA members to participate in this market. It is another matter to layer on anticipated capital charges at 100% of the mark to market variance, and that multiple charges may be incurred during the prolonged settlement cycle of CATs. The multiple layers of underwriting already in place, therefore, provide significant protection against risk at the trade level as well as systemically.

It is for this reason that meeting the 25% TNC / $30MM Threshold for five consecutive business days will not, in all likelihood, be a "rarity." The illustrations show how capital charges can accumulate rapidly with 4 or 5 transactions during an extended settlement cycle. For a firm such as Brean, which has approximately $90 million excess net capital, trades of this size are typical and take place daily. Again, Brean can make such trades because they are neutral to its balance sheet. However, should the Proposed Rule Change take effect, institutional customers in particular will be concerned (entirely reasonably) that regional broker dealers could in a matter of days reach the 25% TNC / $30MM Threshold and not be able to enter into any new CATs, particularly with introducing brokers that are unable to collect margin from or liquidate the securities of customers.

For these reasons, sound underwriting by customers will dictate that they bring their business elsewhere. After all, underwriting is not based on known transactions (the basis for FINRA's "rarity" claim), but on unknown, future transactions and especially on the ability to honor commitments when the market moves against a trade.

B. <u>FINRA's Inability to Address the Many Questions Concerning the Rule's Operation Show that It Is Unworkable</u>

The Notice and Amendment No. 1 do not address the many uncertainties that exacerbate risk identified in comment letters on SR-FINRA-2015-036 and the Notice. Although FINRA proposes to replace the current definition of "mark to market loss", the Proposed Rule Change still does not identify the party responsible for marking-to-market the MBS or the methodology for doing so.[86] As a result, the parties are left to negotiate over these items. But parties setting prices have conflicting interests as buyer and seller and will likely have different views on value in setting margin. It is well established that certain market participants have disproportionate market power.[87] For non-FICC settling Specified Pools and new issue CMOs, there is often no definitive price established by a reliable market, as these securities may be unique or hard to locate, which is why many of these securities do not clear on FICC. As a result of their unique nature, there is a significant risk that marks on these securities will vary from actual value, imposing collateral obligations where none should exist. This risk is multiplied, as margin departments often set value, independent of a trading desk. To do so, they rely on models to price unique securities, which may produce incorrect results.

The Notice did not address the problem presented by the "chain" that is the reality of many CATs. FINRA tries in Amendment No. 1 to address the issues surrounding the requirement that a

[86] Notice, 86 Fed. Reg. at 28164, n.26.
[87] Harkrader & Puglia, *supra* note 8.

position be terminated, *i.e.* sold out, if a party fails to post collateral within five days, but that effort is unsatisfactory, and simply raises additional questions.[88] As discussed above (and shown in Figure A), CATs are generally traded through a chain of buyers and sellers, with modest markups. The vast majority of brokers are hedged, with minimal economic exposure and many brokers may have even executed "riskless trades" (again in the sense of economic impact and net capital calculations) i.e., placing the "buy" order only when a "sale" order was in hand. The reality remains that on a forced liquidation, downstream parties will not be able to locate a substitute security for non-FICC settling Specified Pool and new issue CMO transactions. A non-delivery by one party places all other parties in default, leaving them to sort out who owes what to whom on a difficult-to-price security that has not been delivered through no fault of any downstream party.

We can see in Figure A the consequences of margin default. Using the above assumptions, Dealer #2 is unwilling or unable to reduce its net capital when Dealer #3 can't post collateral. Dealer #2 elects to close out and cancel the trade. On the good day settlement, Dealer #3 will not receive the CMO bond and will not be able to cover its short position since the CMO bond is non-fungible. The remaining trades in the chain will fail for non-delivery, as each will be short the bond with no ability to cover. These parties will almost certainly have no knowledge of the problem until settlement date. Meanwhile Dealer #2, which initially had a riskless position and small profit by virtue of the sale to Dealer #3, will own the bond at current market levels resulting in a loss. After closing out the position of Dealer #3, Dealer #2 might sell the bond, leading to a new chain that closes on the same settlement date. While Institution #4 and Dealer #5 may believe they have sold at a profit, they could have substantial exposure if they had hedged the CMO with a TBA.

For these reasons, the Proposed Rule Change does not mitigate the harm that would be caused by SR-FINRA-2015-036's original proposition that brokers must collect collateral, or liquidate, but

[88] *See* Amendment No. 1 at 10-13.

adds a new, untenable element to each party's risk analysis. The costs and risks associated with this process will only foster uncertainty and deter trading—or lead to higher prices by adding a liquidity premium, harming the consumers. The Proposed Rule Change thus harms investors and, through the harms that will flow through the mortgage market, the American public at large.

To date, one can look to the counterparty's financial strength; going forward, under SR-FINRA-2015-036 and the Proposed Rule Change, *one must consider each trading party with whom the counterparty does business at the time of the trade, i.e.,* parties with whom the firm has no direct dealings, since a failure to meet margin at any point in the chain can lead to a failed settlement further down in the chain. As an example, Brean has already been asked by one counterparty to disclose all of its offsetting positions, so that this counterparty could assess the possible consequences of a default by someone else doing business with Brean.

The chain presents numerous practical problems that have not received consideration in the Notice. For example, there is no real way to foreclose on collateral. Parties in the chain have no securities to liquidate, as would be the norm in margin arrangements, as the security does not exist until settlement date. In addition, multiple parties in the chain could be required to put up margin on the same security, a redundancy that further removes liquidity from the market.

FINRA's proposed elimination of the liquidation requirement when a member firm does not have such right in favor of taking a mark to market loss does not resolve the issues.[89] For the reasons demonstrated above, small and medium-sized firms will rapidly meet the 25% TNC / $30MM Threshold with only a few trades. The pressure multiplies when, as participants in the chain, a counterparty can collect cash margin from *them*.

FINRA opines that it is unlikely that chain fails will occur, "except possibly in circumstances where a counterparty's unwillingness or inability to perform its undisputed obligations makes it equally

[89] *See* Amendment No. 1 at 9-10.

likely that a chain of fails will occur whether or not the member liquidates a transaction with the counterparty."[90] However, the issue is not "the counterparty's unwillingness or inability to perform its undisputed obligations." The issue is that shifting the counterparty's obligations directly onto regional broker-dealers places those broker dealers at solvency risk.

FINRA seems to be in denial on this point. The Proposed Rule Change provides that a firm meeting the 25% TNC / $30MM Threshold "for five consecutive business days . . . shall not enter into any new Covered Agency Transactions with any non-margin counterparty other than risk-reducing transactions."[91] Here, the introducing broker (because it cannot collect margin or liquidate securities) has no means to get out of the penalty box until settlement date, which could be weeks away. In the interim, the firm cannot enter into any CATS with *any* "non-margin counterparty," a constituency that includes an important part of this market. In other words, unlike most margin arrangements, where the concern is the relationship between a broker and a particular customer, FINRA will block new transactions with *all* counterparties. This is an untenable prospect for most institutional investors, who will take their business elsewhere.

FINRA arbitrarily opines that 5-days, with the possibility of a 14-day extension, should suffice to resolve most issues.[92] These time periods do not appear informed by any data, and FINRA has not provided any examples of what might be reasonable circumstances under which extensions will be granted or what factors it might weigh. Parties will be reluctant to engage in this business uncertain that FINRA will grant such extensions and of the standards that will apply.

Nor does Amendment No. 1 (like the Notice) address the role of the clearing broker or reflect that FINRA has considered the actual way in which introducing brokers clear trades. As noted, Pershing, the dominant clearing firm, already imposes by contract margin requirements. Amendment

[90] *Id.* at 10-11.
[91] *Id*. at 30 (Ex. 4, proposed Rule 4210(e)(2)(H)(ii)d.3).
[92] *Id.* at 11-12.

No. 1 does not reference any data that would support that the collateral currently collected by Pershing is not sufficient to protect against the risk the Proposed Rule Change claims to address. Nor does Amendment No. 1 address the inability of many regional broker-dealers to foreclose and receive margin even if a customer posts it with a clearing firm. On this point, the Proposed Rule Change does not provide a mechanism by which an introducing broker will receive a credit for collecting margin if the customer deposits the requisite funds with the clearing firm.

Lastly, regional broker dealers are particularly vulnerable under the standard terms of the Master Securities Forward Transaction Agreement ("MSFTA") developed by SIFMA. Since FINRA announced inclusion of CATs in Rule 4210, many counterparties have required used of the standard form MSFTA, which regional broker-dealers had not previously executed. MSFTAs are not, however, a substitute for a margin agreement and do not require the posting of collateral. In 2018, SIFMA issued a proposed Form of MSFTA that includes CATs in its scope in anticipation of SR-FINRA-2015-036 taking effect. The proposed MSFTA form provides that a broker may close out *all* positions based on a default in *one* position.[93] Any such across-the-board liquidation would not only cause multiple breakdowns in otherwise financially sound chains of distribution, but also threaten the broker with insolvency. The Proposed Rule Change is blind to this reality, and this points to a marked increase in another systemic risk factor, insolvency risk. If a party becomes insolvent, those who have posted collateral with the insolvent party stand to lose their collateral. Thus, one firm's failure is now more likely to impact other firms.[94]

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[93] SIFMA Form of Amendment to Master Securities Forward Transaction Agreement to Conform with FINRA 4210 (Jan. 30, 2018) at ¶8 (https://www.sifma.org/wp-content/uploads/2017/06/2018-MSFTA-Amendment.pdf).

[94] The events of March 2020 provide a real-life scenario of how margin requirements may inadvertantly increase instability and systemic risk at times of market disruption. In March 2020, after the FRB stepped in and provided market liquidity to the TBA market, numerous mortgage lenders faced margin calls on short TBA positions that were being used to hedge mortgages in their pipeline under the terms of MSFTAs with primary dealers. According to the Mortgage Bankers Association ("MBA"), due to the time to settlement date on the TBA shorts,

> broker-dealers' margin calls on mortgage lenders reached staggering and unprecedented levels by the end of the past week. For a significant number of lenders, many of which are well-capitalized, these margin calls are eroding their working capital and threatening their ability to continue to

C. <u>By Reducing the Number of Market Participants, the Rule (Inclusive of the Proposed Rule Change) Will Enhance Systemic Risk</u>

The Proposed Rule Change does not reflect the realities of the market for CATs. It is telling that the Notice's discussion of "Anticipated Costs" speaks in general terms true of any trade regulation, *i.e.,* "The magnitude of these costs depends on the firm's trading activity," rather than evincing any consideration of real-world trading.[95] Amendment No. 1 does not remedy this defect.

The Proposed Rule Change, inclusive of Amendment No. 1, enhances systemic risk in at least five ways: 1) it removes liquidity from the Agency MBS markets; 2) it introduces substantial uncertainty due to the difference between trade prices and the calculation of mark to market loss for margin purposes; 3) FINRA does not offer an adequate solution to the "chain" fail problem; 4) it increases the bargaining power of primary dealers to detriment of introducing brokers; 5) it encourages those broker-dealers with bank affiliates to the shift the business to banks, which will not be subject to Rule 4210 and – in the absence of this onerous regulation – have a far lower cost of capital.

The operation of the Proposed Rule Change would in fact have a heavy and disproportionate financial and regulatory impact on regional broker-dealers, increasing the costs of riskless transactions at least ten-fold. This use of capital will drastically reduce the liquidity that regional broker-dealers bring to the market. These increased costs would also fall heavily on the regional banks and mortgage originators that rely on regional broker dealers to hedge their risks, thereby increasing the cost of originating loans. BDA members have found that primary dealers are ill-fitted to provide these types

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> operate. *MBA has been made aware of many cases in which lenders in strong financial positions only a few days ago will not be able to meet these margin calls after only another day or two of market movements at the pace observed last week.*

MBA Letter to SEC and FINRA (Mar. 29, 2020) (https://www.mba.org/Documents/MBA_Mortgage_Market_Stabilization_3.29.2020.pdf) (emphasis added). The MBA concluded, "The inability of a large set of responsibly-managed lenders to meet these margin calls would jeopardize the very objective of the Federal Reserve's agency MBS purchases – the smooth functioning of both the primary and secondary mortgage markets." *Id.* Neither the Proposed Rule Change nor Amendment No. 1 consider the consequences felt by these market participants in 2020 were SR-FINRA-2015-036 to be implemented.

[95] Notice, 86 Fed. Reg. at 28168.

of institutions with the service they need because of the customers' size or to understand those customers' business and credit needs.

The Proposed Rule Change continues to overlook the ample protections already in place to guard against defaults. Clearing brokers already require introducing brokers to post substantial collateral and effectively already require margin for mark to market losses on when-issued MBS (*see* Illustration 3 above). In addition to the collateral at the clearing firm, regional broker dealers that trade Agency MBS typically have substantial net regulatory capital. Disclosure through monthly focus reports, and other financial data, enables market participants to select fiscally-solvent counterparties. A firm like Brean, which believes it is typical of regional broker-dealers that trade in non-FICC settling Specified Pools and new issue CMOs, has a strong self-interest in remaining fiscally solvent and is well positioned in the event of any market disruption, as was proven out in March of 2020.

The Proposed Rule Change is easily avoided by broker-dealers that have bank affiliates, thereby presenting additional risk. Certain broker-dealers have already shifted trading in CATs to their bank affiliates and now altogether avoid compliance with the Proposed Rule Change, while certain customers have also shifted business to banks, because they are not permitted to post margin or do not want to underwrite the credit risk of doing business with a FINRA broker-dealer. This effectively makes banks a reduced-cost alternative, a significant selling point that puts regional broker-dealers at a severe disadvantage. This migration to a less regulated marketplace leads to another concern. Trades by non-FINRA member banks and their affiliates are not reported on TRACE, reducing transparency and pricing reliability while introducing greater risk and uncertainly into the markets.

V. The Proposed Rule Change Imposes Burdens on Competition that Are Neither Necessary Nor Appropriate

The changes to FINRA Rule 4210 that FINRA has proposed making do not satisfy the requirements of Section 15A. While we commend FINRA for the willingness it has shown to listen to the industry and to attempt to address our concerns, it remains the case that the defects that affected the original rule changes filed on October 14, 2015 remain, for the reasons set forth above, unremedied by the most recent round of proposed amendments. None of these amendments, moreover, removes the impediments to free and open markets that SR-FINRA-2015-036 would erect, or otherwise mitigates the substantial, unwarranted, and unnecessary anti-competitive harms that those changes would have in the market for CATs. For this reason, the Proposed Rule Change should not be approved, and those portions of SR-FINRA-2015-036 that pertain to CATs should be repealed.

As we have consistently maintained throughout this rulemaking process, SR-FINRA-2015-036 suffers from basic and fundamental flaws; namely, were it ever allowed to take effect, it would confer a decisive competitive advantage on larger players in the market, result in the concentration of the market in a handful of institutions, and dramatically reduce liquidity and resiliency in the market for CATs. There are three ways in which the Rule would work these harms to the market and to competition that are of particular concern to the BDA and Brean.

First, the Proposed Rule Change would confer a competitive advantage on those brokers with bank affiliates that are not subject to FINRA's Rule 4210. Because banks are outside the scope of Rule 4210, they are not required to have margin agreements with customers, and are under no obligation to collect margin from their counterparties or to subject their counterparties to mark-to-market margining. An economically rational actor, given the choice between having to post margin to a FINRA member or entirely avoiding this obligation and its associated costs by doing business with a non-member of FINRA, will inevitably choose to conduct its transactions through the non-member. So too, an economically rational actor will likewise, given the choice between conducting its business with a FINRA-member regional broker-dealer that could at any time be prohibited from entering into transactions on its customers' behalf should it reach the 25% TNC / $30MM Threshold or with a non-FINRA-member who is immune from the risk of ever facing such a prohibition, will choose the latter. This is basic economics; indeed, it is simple common sense. Yet, this is the precisely the choice that

SR-FINRA-2015-036 creates, the choice between taking one's business to a non-FINRA member and avoiding costs and burdens, and taking one's business to a FINRA members and incurring those costs and burdens. The Rule thus provides the regional banks and their affiliates to whom they can source inventory, a marked competitive advantage over regional broker-dealers who are FINRA members. And because banks have a lower cost of capital to begin with, Rule 4210 would only be further tilting an already unlevel playing field.

The Proposed Rule Change also places small-to-medium sized brokers at a competitive disadvantage vis-a-vis larger member brokers. It does so, as Brean explained in its comment letter of June 15, 2021, by imposing costs that smaller players, which have generally focused on doing business in what is essentially an economically riskless environment, are less well positioned to bear than larger firms that operate in higher-risk environments, and not only maintain higher operating capital levels, but also generate higher revenues and enjoy larger margins in those high risk environments.

Finally, by creating an incentive for small-to-medium sized brokers to exit the marketplace, SR-FINRA-2015-036, inclusive of the Proposed Rule Change, would also diminish competition, and decrease overall liquidity in the market. Under the regime that SR-FINRA-2015-036 would create, it would not make economic sense for smaller and mid-sized participants, entities that on average engage in only a moderate amount of CATs, to build the compliance systems, hire the new personnel, and implement the margining systems required by the Rule. It is reasonable to assume that these small and midsized brokers will determine that it no longer makes economic sense to remain in the market under the Proposed Rule Change, and will exit the market. As a result, market power will soon become even more concentrated in the hands of a small number of very large investment banks. FINRA continues to decline to explain how a proposed rule that will result in such consolidation, and that will reduce market resilience and liquidity, comports with the requirements of Sections 15A(b)(6) and 15A(b)(9).

The changes announced in Amendment No. 1 do nothing to remedy these defects in SR-FINRA-2015-036. The Proposed Rule still takes no account of the fact that it regulates economically riskless transactions indistinguishably from high-risk transactions. Nor does it reflect the fact that introducing brokers would have to incur charges to regulatory capital, on riskless transactions, at a rate ten-times the current rate. And, finally, as discussed above, Amendment No. 1's effort to mitigate the interference that its liquidation requirements would have on chain transactions would do little, if anything, to remedy the competitive harms caused by SR-FINRA-2015-036.

Indeed, the proposed changes to the liquidation requirement only exacerbate the anticompetitive effects of the Proposed Rule. Under Amendment No. 1, FINRA maintains, a broker would now have to promptly liquidate the CAT positions of its customers only "to the extent of its rights"; thus, "[i]f the member does not have the right to liquidate a counterparty's Covered Agency Transactions, the Proposal does not require the member to liquidate those transactions."[96] In this situation, the member broker would still, of course, have to desist from entering into "any new Covered Agency Transactions with non-margin counterparties other than risk reducing transactions," and, "to the extent of its rights, promptly collect margin for each counterparty's net mark to market loss."[97] In deciding whether to transact through a small or mid-sized broker-dealer rather than through a larger broker-dealer or bank affiliate, therefore, a party will now have to weigh the likelihood that these smaller market participants may suddenly and periodically be unable to conduct transactions on their behalf.

What is more, as the Amendment No. 1 explains in a footnote, while a member is not required "to have a right to liquidate a counterparty's Covered Agency Transactions," consequences follow whenever the broker, in fact, does not have that right:

[96] Amendment No.1 at 10.
[97] *Id.*

> 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 Proposal 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 the Proposal 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.[98]

A member broker would have to relinquish the right to liquidate "any" transactions, even when necessary from a risk management perspective, in order to avoid the obligation to liquidate a position when there is no need to do so. And, when doing so, it would have to subject its customers to rules and procedures that "would likely involve limitations on the extent of the member's business" with that customer.[99] In its effort to avoid the harms that the rule would cause by disrupting chain transactions, Amendment No. 1 thus imposes additional and significant new burdens on competition. The burden is neither necessary nor appropriate because, as FINRA acknowledges, the Amendment does not remedy its original defect; it may still cause chains to fail.[100] From the standpoint of competition, Amendment No.1 simply makes a bad situation even worse.

The Commission can no longer turn a blind eye to these harms to competition and to the securities markets, as they are no longer a matter for speculation, but a matter of fact. As Brean explained in its June 15, 2021 comment letter, the looming threat that SR-FINRA-2015-036 may soon be approved for implementation has already resulted in a marked decline in the competitive position of the smaller and medium-sized broker dealers who are being forced to enter into MSFTAs for bilateral margining with market-dominant primary dealers. It is one thing to dismiss speculation of what might happen as a result of a Proposed Rule change; it is quite another for a self-regulatory

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[98] *Id.*, n.21.
[99] *Id.*
[100] *Id.* at 10-11.

organization, and for the Commission, to ignore the reality of what is already actually happening to the financial markets in response to that Proposed Rule Change.

VI. Conclusion

The core problems created by the Proposed Rule Change are not addressed by Amendment No. 1 and do not resolve the fundamental issues presented by SR-FINRA-2015-036, as currently promulgated. They create too much risk for regional and smaller broker dealers who play an important role in serving middle-market customers and providing liquidity to the markets. For this reason, the Proposed Rule Change cannot be approved, and those portions of SR-FINRA-2015-036 that pertain to CATs must be repealed.

Respectfully submitted,

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