Bond Dealers of America

FINRA Rule 4210

Background:

In October 2015, FINRA filed proposed amendments with the SEC to Rule 4210. The Amendments were approved by the SEC in August 2016, and will require U.S. registered broker-dealers to collect daily variation margin and, in some cases, initial margin, from their customers on specified transactions.

These margin requirements will apply to "Covered Agency Transactions," which include "to-be-announced" (or "TBA") transactions on mortgage-backed securities ("MBS") and specified pool transactions for which the settlement date is more than one business day after the trade date; and U.S. agency collateralized mortgage obligations for which the settlement date is more than three business days after the trade date.

Overview:

BDA feels that the 4210 Amendments are anti-competitive to BDA members.

- Margin requirements will push small- to medium-sized dealers out of the trading of these securities with large buy-side institutions. While the Amendments do not require dealers to have MSFTAs in place with customers, dealers do not believe they can implement effective compliance procedures unless those agreements are in place in case margin thresholds are triggered.

    ✓ BDA expects large buy-side institutions to halt trading these securities with our members due to practical MSFTA demands.

- The Amendments could actually create systemic risk in that they will have the effect of consolidating the trading of these securities into a fewer number of counterparties instead of the broad number and kind of counterparties who currently trade the securities.

    ✓ BDA expects large buy-side institutions to manage their exposure with smaller dealers by reducing trading and outstanding volumes to below the Rule's gross open position limit of $10 million, making the required movement of margin unlikely. Larger trades will be consolidated into a fewer number of dealers – increasing risk to the market.

Potential Solutions Put Forward by BDA:

- In June 2016, BDA was successful in getting FINRA and SEC to file an amendment to the Rule that significantly expanded the "gross open position" exception from $2.5 million to $10 million. BDA had advocated for a more expansive gross open position limit throughout the rulemaking and the $10 million level expands the universe of counterparties and trades where the transfer of margin will typically not apply.

- BDA supports excluding transactions from the "Covered Agency Securities" definition that do not pose systemic risk:

  - ✓ Specified pools and CMOs do not pose systemic risk because they are merely bond trades comprising a small percentage of the market. They are of a different kind of transaction altogether from most TBAs that are frequently used as hedging instruments.

- BDA supports excluding transactions from the "Covered Agency Securities" definition that settle on the next or first good settlement date:

  - ✓ CMOs that settle either T+2 or on their first settlement date along with Specified MBS pools and TBAs that settle on their next good settlement date are effectively bond trades and do not pose the systemic risk that the Amendments seek to manage.

- BDA has asked FINRA to allow dealers to take the capital charge instead of requiring them to enter into margining agreements with customers.

  - ✓ BDA believes that FINRA should revise the Amendments to allow dealers to either charge margin to counterparties or to take a regulatory capital charge to cover any mark to market deficiency in excess of the de minimis threshold.

  - ✓ This would allow dealers to remain competitive with money manager accounts and still manage any systemic risk. Other margin requirements are handled through a capital charge rather than collecting customer margin – corporate bonds are one such example.

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BDA Actions and Next Steps on 4210 Amendments:

- BDA submitted comments on 4210 Amendments to the SEC in 2015 and 2016, and worked with Sen. Tom Cotton (R-Arkansas) on his comments as well.

- In 2016, BDA also successfully advocated for the wider "gross open position."

- BDA met with the SEC again in January and May 2017 to discuss concerns and advocate for additional changes, which were outlined in a letter submitted to FINRA in August 2017. In August and September 2017, BDA facilitated conference calls between members to answer compliance and interpretive questions regarding 4210.

- **In September 2017, FINRA filed a proposed rule to delay the major effective date of the rule until June 25, 2018.**

- **In December 2017, BDA member firms met with FINRA CEO Robert Cook and urged FINRA consider a new solution to the margin requirements under Rule 4210. This BDA-member proposal would allow dealers to either charge margin to counterparties or to take a regulatory capital charge to cover any mark-to-market deficiency in excess of the de minimis threshold. This would allow dealers to remain competitive and still manage any systemic risk in the marketplace.**

- BDA has continued to stay in touch with FINRA on this issue, and also discussed 4210 Amendments in-person with SEC Chairman Clayton and SEC commissioners in January 2018.

- **In February 2018, BDA received confirmation that FINRA is considering a change to Rule 4210 based on the capital charge idea BDA members brought up during the December 2017 meeting. FINRA has connected with a number of BDA member firms to gather more information regarding this idea.**

- Moving forward, BDA is gathering more evidence of anti-competitive impacts of 4210 Amendments that we can send to FINRA in support of BDA member firms.

- BDA has also remained active with a number of other industry groups on this issue. BDA is exploring political avenues, including additional pressure on the SEC and key members of Congress.