

An overview of the FINRA Rule 4210 margin amendments

Nikiforos Mathews and Jonas Robison

Abstract

Purpose – To summarize for registered broker-dealers and their customers upcoming margin requirements for “to-be-announced” (TBA) transactions on mortgage-backed securities pursuant to recently-amended FINRA Rule 4210.

Design/methodology/approach – This article explains the various margin requirements that are expected to come into effect on June 25, 2018. A chart summarizing the applicability of margin requirements for various types of accounts is also provided. Additionally, the article addresses practical steps to bring Master Securities Forward Transaction Agreements (“MSFTAs”) governing relevant transactions into compliance with the amended rules.

Findings – The compliance date for margining under FINRA Rule 4210 is approaching. Broker-dealers will be required to collect (but not post) daily variation margin and, depending on the type of account, maintenance margin, from their customers on specified transactions. Broker-dealers should become familiar with the relevant requirements in order to amend (or enter into new) MSFTAs by the deadline. Customers also should become familiar with, and consider the implications of, these margin requirements.

Originality/value – Concisely summarizes and explains the key requirements and provides practical guidance regarding compliance from experienced derivatives attorneys.

Keywords Financial Industry Regulatory Authority (FINRA), US Securities and Exchange Commission (SEC), Broker-dealer, FINRA Rule 4210, TBA transactions

Paper type Technical paper

Nikiforos Mathews (nmathews@orrick.com) is a partner and Jonas Robison (jrobison@orrick.com) is a managing associate at Orrick, Herrington & Sutcliffe LLP in New York, NY, USA.

Amendments approved by the Securities and Exchange Commission (“SEC”) last year to FINRA Rule 4210[1] will require registered broker-dealers to collect (but not post) daily variation margin and, in some cases, maintenance margin, from their customers on specified transactions[2]. These new requirements were developed in response to the financial crisis based, in part, on the 2012 recommendations of the Treasury Markets Practice Group sponsored by the Federal Reserve Bank of New York[3]. The amendments to the rule were scheduled to take effect on December 15, 2017. However, FINRA recently filed a proposed rule with the SEC to postpone the compliance date until June 25, 2018[4].

The new margin requirements apply to “Covered Agency Transactions”, which include: (i) “to-be-announced” (or “TBA”) transactions[5] for which the settlement date is more than one business day after the trade date; (ii) specified pool transactions[6] for which the settlement date is more than one business day after the trade date; and (iii) US agency collateralized mortgage obligations for which the settlement date is more than three business days after the trade date[7]. TBA transactions account for the vast majority of trading in the sizable agency mortgage-backed securities (“MBS”) market[8].

The new margin rules generally provide that full mark-to-market (or “variation”) margin is required daily from each separate counterparty, without any “threshold” or similar level of uncollateralized exposure. Positions in the same account may be netted to arrive at a single

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amount of variation margin to be transferred. Margin transfers may be subject to a minimum transfer amount of no more than \$250,000.

Additional (or “maintenance”) margin is also required in an amount equal to two percent of the contract value of each net long or short position, by CUSIP, of a customer. However, maintenance margin is not required from “exempt accounts”, which generally include the following:

1. an account of a broker-dealer;
2. a “designated account”, which is defined to include the account of a bank, savings association, insurance company, registered investment company, state or political subdivisions thereof, and pension or profit-sharing plan either subject to ERISA or of an agency of the United States or of a state or political subdivision thereof;
3. an account of any person (sometimes referred to as a “large entity”) that has a net worth of at least \$40 million and financial assets of at least \$45 million and either:
 - satisfies certain specified Securities Exchange Act-related reporting requirements; or
 - makes available to the broker-dealer such current information regarding its ownership, business, operations and financial condition as reasonably believed by the broker-dealer to be accurate and sufficient for purposes of performing a risk analysis in respect of such person; and
4. an account of a mortgage banker^[9] that is entering into the agreement to hedge its pipeline of mortgage commitments^[10].

In addition, maintenance margin is not required from a *non*-exempt account with respect to a transaction if (i) the original contractual settlement for the transaction is in the month of the trade date or in the month succeeding the trade date and (ii) the customer regularly settles^[11] its Covered Agency Transactions on a delivery-versus-payment (“DVP”) basis or for cash, so long as the account does not engage in “dollar-rolls”^[12], “round robin”^[13] trades or other financing techniques for its Covered Agency Transactions with the broker-dealer.

The new margin requirements (both maintenance and variation) do not apply to transactions that are cleared through a registered clearing agency^[14] and that are subject to the margin rules of that clearing agency. The new margin requirements (both maintenance and variation) also do not apply to any customer that has a gross open position in Covered Agency Transactions with a broker-dealer of \$10 million or less if, generally, (i) the original contractual settlement for all such transaction is in the month of the trade date or in the month succeeding the trade date and (ii) such customer regularly settles such transactions on a DVP basis or for cash, so long as such customer does not engage in dollar-rolls, round robin trades or other financing techniques for its Covered Agency Transactions with the broker-dealer. In addition, a broker-dealer may elect not to apply the new margin requirements to any Federal banking agency, as defined in 12 U.S.C. 1813(z), central bank, multinational central bank, foreign sovereign, multilateral development bank, or the Bank of International Settlements (sometimes referred to as a “sovereign account”)^[15].

For ease of reference, [Table I](#) summarizes the applicability of margin requirements for various types of accounts upon the effectiveness of the amendments to FINRA Rule 4210.

If a maintenance or variation margin requirement is not satisfied by the close of business on the business day immediately following the business day on which the margin deficiency arose, then the broker-dealer must deduct the unsatisfied amount from its regulatory net capital, as provided in Rule 15c3-1 of the Securities Exchange Act. Moreover, if a maintenance or variation margin requirement remains unsatisfied five business days after the date the deficiency arose, then the broker-dealer must promptly liquidate positions to satisfy the deficiency, absent an extension of time granted by FINRA^[16].

Table I Overview of margin requirements under amended FINRA Rule 4210^a

<i>Type of account (uncleared covered agency transactions)</i>	<i>Maintenance margin (two percent contract value of net long/short, by CUSIP)</i>	<i>Variation margin (full mark-to-market margin)</i>
Non-exempt accounts (including mortgage bankers <i>not</i> satisfying hedging condition)	Yes, except for transactions in which the original contractual settlement is in the month for the trade date or in the month succeeding the trade date, subject to certain other conditions	Yes
Exempt accounts		Yes
Broker-dealer	No	
Designated account	No	
Large entity	No	
Mortgage bankers satisfying hedging condition	Broker-dealer may elect not to apply	
Exempt accounts or non-exempt accounts having gross open positions of \$10 million or less and satisfying other conditions	No	No
Sovereign accounts	Broker-dealer may elect not to apply	Broker-dealer may elect not to apply

Notes: ^aThis table is intended to provide only a brief overview of the applicability of margin requirements for various types of accounts upon the effectiveness of the amendments to FINRA Rule 4210. The determination of whether a transaction or account is subject to these new margin requirements may be nuanced and complex.

Many market participants currently do not exchange margin on Covered Agency Transactions, which are typically documented under Master Securities Forward Transaction Agreements (known as “MSFTAs”), published by Securities Industry and Financial Markets Association (“SIFMA”), the most recent version of which was published in 2012. Therefore, compliant margin provisions may need to be negotiated for existing MSFTAs (or an entirely new MSFTA with a compliant margin annex may need to be negotiated where currently there is no such master agreement) in connection with Covered Agency Transactions between broker-dealers and their customers. In addition, triparty control agreements with custodians also may be necessary where customers are registered investment companies.

To facilitate the amendment of existing MSFTAs to make them compliant with amended FINRA Rule 4210, SIFMA has published a form of amendment^[17]. Among other things, the SIFMA Form of Amendment provides for full variation margin to be posted by one or both parties by setting their threshold of uncollateralized exposure at zero. It also provides for a bilateral minimum transfer amount ceiling of \$250,000. In addition, the SIFMA Form of Amendment provides for representations to be made by each party as to its status under FINRA Rule 4210, which is intended to assist the broker-dealer in determining the margin requirements that will apply to the relationship, including, for example, whether a party is an exempt account (*i.e.*, broker-dealer, a designated account, a large entity or a mortgage banker that is entering into the agreement to hedge its pipeline of mortgage commitments) or a sovereign account. Moreover, the SIFMA Form of Amendment includes language setting a floor for maintenance margin of two percent of the net long or short position, by CUSIP, for the relevant Covered Agency Transactions where the broker-dealer has determined that the other party is not an exempt account or does not qualify for another exception to the maintenance margin requirements. The SIFMA Form of Amendment also includes language allowing the broker-dealer, in addition to any other rights it may have under the agreement, to terminate “any or all” trades thereunder as if an event of default had occurred with respect to such transactions if the counterparty fails to transfer the required margin within five business days of a deficiency arising^[18].

Upon the effectiveness of the FINRA Rule 4210 rule changes, both existing and new Covered Agency Transactions will become subject to the new margin requirements.

Notes

1. 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, 81 Fed. Reg. 40364 (June 21, 2016) ("Final Amendments").
2. FINRA Rule 4210, as amended, also generally required a designated credit risk officer or committee of a broker-dealer to determine in writing and enforce, in accordance with the broker-dealer's written risk policies and procedures, a risk limit for each customer to Covered Agency Transactions by December 2016. In the case of registered investment advisors, broker-dealers were permitted to set these risk limits at the level of the advisor, as opposed to the level of each advisory client. Nevertheless, FINRA has noted that it "expects [broker-dealers] to exercise appropriate diligence in understanding the extent of their risk and to craft their risk limit determination accordingly" in making risk determinations as to advisory accounts. Final Amendments at 40370.
3. See Treasury Markets Practices Group, *Best Practices for Treasury, Agency Debt, and Agency Mortgage Backed Securities* (June 2015) (the "TMPG Best Practices"), available at: www.newyorkfed.org/medialibrary/microsites/tmpg/files/TMPG_June%202015_Best%20Practices.pdf. Specifically, these recommendations stated that "[t]o help both parties mitigate counterparty risk owing to market value changes, two-way margin should be exchanged on a regular basis" and that "[w]ritten master agreements should describe the parties' agreement on all aspects of the margining regime, including collateral eligibility, timing and frequency of margin calls and exchanges, thresholds, valuation of exposures and collateral, and liquidation". *Id.* at 4-5. In a significant departure from the recommendations set forth in the TMPG Best Practices, the amendments to FINRA Rule 4210 require only *one-way* collateral exchanges, although parties may, of course, negotiate bilateral margining.
4. See Self-Regulatory Organization; Financial Industry Regulatory Authority, Inc.; Notice of Filing and Immediate Effectiveness of a Proposed Rule Change to Delay the Implementation Date of Certain Amendments to FINRA Rule 4210 Approved Pursuant to SR-FINRA-2015-036, 82 Fed. Reg. 45,915 (October 2, 2017).
5. The TBA market facilitates the forward trading of MBS issued by Fannie Mae, Freddie Mac and Ginnie Mae. See SIFMA TBA Market Fact Sheet, at 1, available at: www.sifma.org/wp-content/uploads/2017/05/us-tba-fact-sheet.pdf (the "SIFMA Fact Sheet"). In a TBA trade, the parties agree on six parameters of the securities to be delivered (issuer, maturity, coupon, price, par amount and settlement date), but the actual identity of the securities to be delivered at settlement is not specified. See, e.g., James Vickery and Joshua Wright, *TBA Trading and Liquidity in the Agency MBS Market*, Federal Reserve Bank of New York Economic Policy Review (May 2013) ("Staff Report"), at 5, available at: www.newyorkfed.org/medialibrary/media/research/epr/2013/1212vick.pdf. TBA trades generally settle within three months of the trade date and, to facilitate logistics for settlement, the market sets a single settlement date for each month for each of several types of trades. *Id.* at 6. Consistent with industry practice, the seller notifies the buyer of the details of the pool to be delivered two business days before the settlement date (this is known as the "48 hour rule"). See generally *SIFMA*, Uniform Practice Manual, available at: www.sifma.org/resources/general/tba-market-governance/#up
6. In specified pool trades, the actual identity of the pool to be delivered is specified on the trade date.
7. Note, however, that broker-dealers are not required to apply the margin requirements with respect to Covered Agency Transactions with a customer that involve multifamily housing securities or project loan program securities and satisfy specified criteria, including that such securities are issued in conformity with a program of an agency (as defined in FINRA Rule 6710(k)) or a Government-Sponsored Enterprise (as defined in FINRA Rule 6710(n)).
8. Staff Report, at 2. In June 2015, an average of \$184 billion of agency MBS was traded each day by primary dealers. SIFMA Fact Sheet, at 1. This volume dwarfs the size of the corporate bond and municipal markets, and is second only to the US Treasury market. *Id.*

9. The term "mortgage banker" is defined as "an entity, however organized, that engages in the business of providing real estate financing collateralized by liens on such real estate". Final Amendments at 40366.
10. Subject to specified conditions, broker-dealers may treat mortgage brokers that hedge their pipeline of mortgage commitments as exempt accounts, in which case they would not be subject to maintenance margin requirements. *Id.* at 40367. Broker-dealers must apply the new maintenance and variation margin requirements to the accounts of mortgage brokers who do not satisfy this hedging condition.
11. The term "regularly settles" is intended to provide broker-dealers with flexibility as to how they implement the requirement. FINRA Regulatory Notice 16-31, 12 n.18 (August 2016) (the "FINRA Regulatory Notice"), available at: www.finra.org/sites/default/files/notice_doc_file_ref/Regulatory-Notice-16-31.pdf. FINRA expects that broker-dealers are "in a position to make reasonable judgments as to the observed pattern and course of dealing in their customers' behavior by virtue of their interactions with their customers". *Id.* FINRA has noted that it views the term "regularly" as conveying the "prevailing or dominant pattern and course of the customer's behavior" and that, in making their determinations, broker-dealers may use the customer's history of transactions with the broker-dealer and any other relevant information of which the broker-dealer is aware, and also should be able to rely on the reasonable representations of their customers. *Id.*
12. The term "dollar roll" means "a simultaneous sale and purchase of an [agency MBS] [. . .] for different settlement dates, where the initial seller agrees to take delivery, upon settlement of the re-purchase transaction, of the same or substantially similar securities". FINRA Rule 6710(z).
13. "Round robin" trades are transactions resulting in equal and offsetting positions by one customer with two separate dealers for the purpose of eliminating a turnaround delivery obligation by the customer. See Final Amendments at 40366.
14. The term "registered clearing agency" means a clearing agency, as defined in Section 3(a)(23) of the Securities Exchange Act that is registered with the SEC pursuant to Section 17A(b)(2) of the Securities Exchange Act. FINRA Rule 4210(f)(2)(A)(xxviii).
15. Final Amendments at 40366.
16. FINRA has indicated that it "expects to establish a process that [broker-dealers] may use to request extensions of time specifically related to Covered Agency Transactions". FINRA Regulatory Notice, at 7. Specifically, FINRA intends to announce prior to the effective date of the new margin requirements updates to its existing Regulatory Extension System (known as "REX") to accommodate requests for extensions of time related to Covered Agency Transactions. *Id.* at 13 n. 25.
17. SIFMA, Form of Amendment to Master Securities Forward Transaction Agreement to Conform with FINRA 4210, SIFMA Form Version: March 9, 2017 ("SIFMA Form of Amendment"), available at: www.sifma.org/wp-content/uploads/2017/08/2017-MSFTA-Amendment-Clean-2017-03-09.pdf
18. This provision could apply bilaterally where both parties are broker-dealers or if the parties so agree.

Corresponding author

Nikiforos Mathews can be contacted at: nmathews@orrick.com

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