SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-98003; File No. SR-FINRA-2021-010)

July 27, 2023

Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Order Setting Aside Action by Delegated Authority and Granting Approval of 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

I. Introduction

A. Overview

1. Rulemaking by Self-Regulatory Organizations

The Financial Industry Regulatory Authority, Inc. ("FINRA") is registered with the Securities and Exchange Commission ("Commission" or "SEC") as a national securities association under the Securities Exchange Act of 1934 ("Exchange Act" or "Act").[1] Under the Exchange Act, the rules of a national securities association for its broker-dealer members[2] must, among other things, be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, or processing information with respect to (and facilitating transactions in) securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest.[3] Further, under the Exchange Act, the rules of a national securities association

---

1 See 15 U.S.C. 78*o*-3(a).

2 See 15 U.S.C. 78c(a)(3)(B) (defining the term "member" when used with respect to a registered securities association to mean any broker or dealer who agrees to be regulated by such association and with respect to whom the association undertakes to enforce compliance with the Exchange Act, the rules and regulations thereunder, and its own rules).

3 See 15 U.S.C. 78*o*-3(b)(6).

must not impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Act.[4]

FINRA, as a national securities association, also is a self-regulatory organization ("SRO") under the Exchange Act and its proposed rules are subject to Commission review and published for notice and comment.[5] While certain types of proposed rules are effective upon filing, others are subject to Commission approval before they can go into effect.[6] Under the Exchange Act, the Commission must approve an SRO's proposed rule if the Commission finds that the proposed rule change is consistent with the requirements of the Act and the applicable rules and regulations thereunder; if it does not make such a finding, the Commission must disapprove the proposed rule.[7] The SRO has the burden to demonstrate that a proposed rule change is consistent with the Exchange Act and the rules and regulations issued thereunder.[8]

The Exchange Act sets forth timeframes in which the Commission must either approve, disapprove, or institute proceedings to determine whether to approve or disapprove an SRO's proposed rule.[9] If the Commission institutes proceedings, the Exchange Act sets forth timeframes in which the Commission must complete the proceedings and either approve or disapprove the SRO's proposed rule.[10]

The Commission has delegated authority to the staff of its Division of Trading and Markets ("Division") to publish notice of an SRO's proposed rule for comment and to approve,

---

4 See 15 U.S.C. 78*o*-3(b)(9).

5 See 15 U.S.C. 78s(a) and (b).

6 See 15 U.S.C. 78s(b).

7 See 15 U.S.C. 78s(b)(2)(C).

8 17 CFR 201.700(b)(3).

9 See 15 U.S.C. 78s(b)(2).

10 See 15 U.S.C. 78s(b)(2)(B).

disapprove, or institute proceedings to determine whether to approve or disapprove the proposed rule.[11] Under the Commission's Rules of Practice, any person aggrieved by the Division's exercise of delegated authority may seek Commission review of the action by filing with the Commission: (1) a notice of intention to petition for review; and (2) a subsequent petition for review containing a clear and concise statement of the issues to be reviewed and the reasons why review is appropriate.[12] The notice must be filed within fifteen days of the publication in the Federal Register of the action taken by the Division pursuant to delegated authority (e.g., publication of an order approving an SRO proposed rule) and the petition must be filed within five days after the filing of the notice.[13] The Commission may grant or deny the petition for review.[14] If the petition for review is granted, the Commission may affirm, reverse, modify, set aside, or remand for further proceedings, in whole or in part, the action made by the Division pursuant to delegated authority (e.g., the approval of an SRO proposed rule).[15]

2. FINRA's Amendments to Rule 4210

Most residential mortgages in the United States are securitized, with the underlying loans pooled into a separate legal trust, which issues mortgage-backed securities and passes on mortgage payments to investors after deducting mortgage servicing fees and other expenses.[16] In the agency market, each mortgage-backed security carries a credit guarantee from Fannie Mae,

---

11 See 17 CFR 200.30-3(a)(12) and (57).

12 See 17 CFR 201.430(b)(1) and (2). The petition must include exceptions to any findings of fact or conclusions of law made, together with supporting reasons for such exceptions based on appropriate citations to such record as may exist. 17 CFR 201.430(b)(2).

13 See 17 CFR 201.430(b)(1) and (2).

14 See 17 CFR 201.431(b).

15 See 17 CFR 201.431(a).

16 See James Vickery & Joshua Wright, TBA Trading and Liquidity in the Agency MBS Market, Federal Reserve Bank of New York, Economic Policy Review (May 2013) at 2 (cited in Letter to Vanessa Countryman, Commission, from David H. Thompson. et. al., at 6-7 (Feb. 3, 2022) ("Petition for Review")), available at https://www.sec.gov/rules/sro/finra/2022/34-94013-petn-cooper-kirk-020322.pdf).

Freddie Mac, or Ginnie Mae.[17] Most agency mortgaged-backed security trading is conducted in the To-Be-Announced ("TBA") market, with defined settlement dates for each month in the future.[18] Most TBA transactions are nettable and clear through the Mortgage-Backed Securities Division of the Fixed Income Clearing Corporation ("MBSD").[19] Mortgage bankers may enter into a TBA transaction with a forward settlement date to hedge their mortgage pipeline.[20] Agency mortgage-backed securities are debt instruments and may qualify as exempted securities under Section 3(a)(12)(A) of the Exchange Act.[21] Investors in the TBA market include, for example, banks, investment companies, investment funds, insurance companies, real estate investment trusts, and mortgage originators.[22]

Broker-dealers often require customers to post collateral or "margin" to them in the form of cash or other securities in connection with the purchase and sale of securities. The requirement to post margin to a broker-dealer can be mandated by laws or regulations or agreed to by contract (provided the contract complies with minimum regulatory requirements). Broker-dealers may collect margin from customers for several purposes including, for the initial purchase of securities ("initial margin"), to maintain a minimum equity in the customer's account

---

17 See Petition for Review at 7; U.S. Credit Markets: Interconnectedness and the Effects of the COVID-19 Economic Shock (Oct. 2020) at 62, available at https://www.sec.gov/files/US-Credit-Markets_COVID-19_Report.pdf ("DERA Report") (cited in Exchange Act Release No. 91937 (May 19, 2021), 86 FR 28161, 28162, n.17 (May 25, 2021) ("Notice")).

18 See Petition for Review at 9; DERA Report at 62; SIFMA TBA Market Fact Sheet (2015) at 2 (cited in Petition for Review at 9, n.10).

19 See Petition for Review at 9.

20 See Letter from Pete Mills, Senior Vice President, Residential Policy and Strategic Industry Engagement, Mortgage Bankers Association (May 10, 2022) ("MBA Letter") at 1-2.

21 15 U.S.C. 78c(a)(12)(A). Exempted securities include U.S. Treasury securities or other securities which are direct obligations of, or obligations guaranteed as to principal or interest by, the United States or securities which are issued or guaranteed by corporations in which the United States has a direct or indirect interest (such as Fannie Mae and Freddie Mac).

22 See DERA Report at 63.

("maintenance margin"), or to cover changes in the market value (or mark to market value) of the securities in the account ("variation margin"). In the securities markets, the Board of Governors of the Federal Reserve System ("Federal Reserve Board") and SROs have set margin rules since the 1930s. The Federal Reserve Board generally sets initial margin requirements for broker-dealers in Regulation T.[23] For example, Regulation T prescribes a 50% initial margin requirement for listed equity securities (meaning the customer must pay at least 50% of the market value of a listed equity security when purchasing it in a transaction financed by the broker-dealer). Regulation T also provides that the initial margin requirement for good faith securities—which includes exempted securities and non-equity securities (e.g., debt securities)—is the greater of the margin the broker-dealer requires in good faith or the amount an SRO requires.[24] Agency securities (such as TBA securities) are good faith securities under Regulation T because they are debt securities, exempted securities, or both. SROs, such as FINRA, generally set maintenance margin requirements for their broker-dealer members. FINRA's primary margin rule for its broker-dealer members is FINRA Rule 4210 (Margin Requirements) ("Rule 4210"). For example, FINRA Rule 4210 prescribes a 25% maintenance margin requirement for listed equity securities (meaning the customer must maintain equity of at least 25% of the market value of the security). Consistent with the margin requirements for good faith securities under Regulation T, FINRA Rule 4210 also prescribes margin requirements for exempted securities (such as U.S. Treasury securities and agency securities), as well as

---

[23] See 12 CFR 220.1, et. seq.

[24] See 12 CFR 220.6(a)(2) and 220.12(b).

transactions in exempted securities, mortgage related securities, or major foreign sovereign debt securities in an exempt account.[25]

Prior to 2016, however, FINRA Rule 4210 did not specifically address the market for TBAs and other similar agency forward-settling transactions. In 2015, FINRA filed a proposed rule change under SR-FINRA-2015-036 to amend FINRA Rule 4210 to establish requirements for: (1) TBA transactions,[26] inclusive of adjustable rate mortgage ("ARM") transactions; (2) Specified Pool Transactions;[27] and (3) transactions in Collateralized Mortgage Obligations ("CMOs")[28] issued in conformity with a program of an agency[29] or Government-Sponsored Enterprise ("GSE"),[30] with forward settlement dates (collectively, "Covered Agency

---

25 See FINRA Rule 4210(e)(2)(A), (B) and (F). See also infra note 86 (defining "exempt account" under FINRA Rule 4210(a)(13)).

26 See FINRA Rule 6710(u) defining TBA to mean a transaction in an Agency Pass-Through mortgage-backed security or a Small Business Administration ("SBA")-Backed Asset-Backed Security ("ABS") where the parties agree that the seller will deliver to the buyer a pool or pools of mortgages 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, and includes TBA transactions for good delivery and TBA transactions not for good delivery.

27 See FINRA Rule 6710(x) defining Specified Pool Transaction to mean a transaction in an Agency Pass-Through mortgage-backed security or an SBA-Backed ABS requiring the delivery at settlement of a pool or pools that is identified by a unique pool identification number at the Time of Execution.

28 See FINRA Rule 6710(dd) defining "CMO" to mean a type of Securitized Product backed by Agency Pass-Through mortgage-backed securities, mortgage loans, certificates backed by project loans or construction loans, other types of mortgage-backed securities or assets derivative of mortgage-backed securities, structured in multiple classes or 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, and includes a real estate mortgage investment conduit ("REMIC").

29 See FINRA Rule 6710(k) defining "agency" to mean a United States executive agency as defined in 5 U.S.C. 105 that is authorized to issue debt directly or through a related entity, such as a government corporation, or to guarantee the repayment of principal or interest of a debt security issued by another entity. The term excludes the U.S. Department of the Treasury in the exercise of its authority to issue U.S. Treasury Securities as defined under FINRA Rule 6710(p). Under 5 U.S.C. 105, the term "executive agency" is defined to mean an "Executive department, a Government corporation, and an independent establishment."

30 See FINRA Rule 6710(n) defining "GSE" to have the meaning set forth in 2 U.S.C. 622(8). Under 2 U.S.C. 622(8), a GSE is defined, in part, to mean a corporate entity created by a law of the United States that has a Federal charter authorized by law, is privately owned, is under the direction of a board of directors, a majority of which is elected by private owners, and, among other things, is a financial institution with power to make loans or loan guarantees for limited purposes such as to provide credit for

Transactions," also referred to, for purposes of this order, as the "TBA market"). Broadly, the amendments required FINRA's broker-dealer members to: (1) perform credit risk determinations for counterparties with whom the broker-dealer engages in Covered Agency Transactions; and (2) collect margin from counterparties with respect to their Covered Agency Transactions with the broker-dealer.

As discussed below, FINRA's initial amendments to Rule 4210 regarding Covered Agency Transactions went through a notice and comment period during which FINRA filed three amendments to the proposed rule change that, among other things, responded to comments about the potential burdens of the proposed rule change, including the potential burdens on smaller broker-dealers.[31] In June 2016, the Division, pursuant to delegated authority, approved FINRA's amendments to Rule 4210 ("2016 Amendments").[32] No petition was filed with the Commission to review the staff's exercise of delegated authority to approve the 2016 Amendments.

Under the 2016 Amendments, FINRA's broker-dealer members must make and enforce a written risk limit determination for each counterparty with whom the broker-dealer engages in Covered Agency Transactions.[33] The effective date for the credit risk determination requirement was December 15, 2016 and, therefore, FINRA's broker-dealer members currently are subject to this requirement. Further, under the 2016 Amendments, FINRA's broker-dealer members

---

specific borrowers or one sector and raise funds by borrowing (which does not carry the full faith and credit of the Federal Government) or to guarantee the debt of others in unlimited amounts.

31 See section I.B.1. of this order (discussing the procedural history of the notice and comment period for the 2016 Amendments).

32 Exchange Act Release No. 78081 (June 15, 2016), 81 FR 40364, 40375 (June 21, 2016) (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; File No. SR-FINRA-2015-036) ("2016 Approval Order").

33 See Rule 4210(e)(2)(H)(ii)(b).

(unless an exception applies) must collect the daily mark to market loss from all counterparties with respect to their Covered Agency Transactions and for non-exempt accounts also collect maintenance margin of two percent.[34] The effective date for these margin collection requirements is October 25, 2023.[35]

With respect to the 2016 Amendments, FINRA stated it would consider amending them as may be necessary to mitigate their impact on smaller broker-dealers.[36] Interested parties told FINRA that the 2016 Amendments favor larger broker-dealers because they have more market power to negotiate margin agreements or Master Securities Forward Transactions Agreements ("MSFTAs") with their counterparties, and that smaller broker-dealers also are at a competitive disadvantage to non-FINRA members (i.e., regional banks) because these entities are not subject to margin requirements for Covered Agency Transactions. Additionally, some smaller broker-dealers told FINRA that, among other things, the ability to take a capital charge in lieu of collecting margin would help alleviate this competitive disadvantage, though it would not fully resolve the competitive disparity between FINRA's broker-dealer members subject to FINRA Rule 4210 and regional banks that are not subject to similar margin requirements.[37]

To address these concerns, FINRA filed a proposed rule change in 2021 (SR-FINRA-2021-010) to amend the margin collection requirements for Covered Agency Transactions in

---

34 See Rule 4210(e)(2)(H)(i) and (ii) under the 2016 Amendments. Under the 2016 Amendments, the daily mark to market loss is a counterparty's loss (i.e., the broker-dealer's gain) resulting from marking a Covered Agency Transaction to the market. See Rule 4210(e)(2)(H)(i)g. The maintenance margin amount is two percent of the contract value of the net "long" or net "short" position in Covered Agency Transactions, by CUSIP, with the counterparty. See Rule 4210(e)(2)(H)(i)f. An exempt account is an account of another broker-dealer or a person with a net worth of at least $45 million and financial assets of at least $40 million and who meets one of five other conditions. See Rule 4210(a)(13). See also infra note 86 (defining "exempt account" under FINRA Rule 4210(a)(13)).

35 See Exchange Act Release No. 97062 (Mar. 7, 2023), 88 FR 15473 (Mar. 13, 2023) (File No. SR-FINRA-2023-002).

36 See 2016 Approval Order, 81 FR at 40375.

37 See Notice, 86 FR at 28162.

Rule 4210 that were adopted under the 2016 Amendments. As discussed below, FINRA's proposed amendments went through a notice and comment period during which FINRA filed one amendment that, among other things, responded to comments about the potential burdens of the proposal.[38] Generally, as discussed below, the proposed amendments are intended to further reduce the burdens of the margin collection requirements with respect to Covered Agency Transactions, particularly for smaller broker-dealers. In January 2022, the Division, pursuant to delegated authority, approved these amendments ("2021 Amendments").[39]

As discussed below, the 2021 Amendments would (among other things): (1) eliminate the two percent maintenance margin requirement that applies to non-exempt accounts; (2) permit broker-dealers to take a capital charge in lieu of collecting the mark to market loss, subject to specified conditions and limitations; and (3) make revisions designed to streamline, consolidate, and clarify the text of the rule. The 2021 Amendments also include an implementation schedule for the requirements in Rule 4210 pertaining to collecting margin with respect to Covered Agency Transactions, as those requirements would be amended by the 2021 Amendments ("Amended Margin Collection Requirements"). The implementation schedule provides that FINRA would announce the effective date for the Amended Margin Collection Requirements no later than 60 days following the Commission's approval of the 2021 Amendments and the announced effective date would be between nine and ten months following the approval.

In February 2022, the Bond Dealers of America ("BDA") and Brean Capital, LLC ("Brean Capital") (collectively, the "Petitioners") jointly filed a timely petition requesting that

---

38 See section I.B.2. of this order (discussing the procedural history of the 2021 Amendments).

39 See Exchange Act Release No. 94013 (Jan. 20, 2022), 87 FR 4076 (Jan. 26, 2022) (SR-FINRA-2021-010) ("2022 Approval Order").

the Commission review the Division's approval of the 2021 Amendments.[40] The Commission granted the Petition for Review and, thereby, agreed to review the Division's action under delegated authority.[41]

The Petitioners requested that the Commission disapprove the 2021 Amendments. Procedurally, if the Commission disapproves the 2021 Amendments, the 2016 Amendments would remain in place and become effective on October 25, 2023. Among other things, this would mean that the Amended Margin Collection Requirements—which would reduce certain burdens of the 2016 Amendments—would not take effect.

In response to the Petition for Review, the Commission has conducted a de novo review of the Division's action by delegated authority approving the 2021 Amendments. The review gave careful consideration to the entire record—including FINRA's filings, the comments and statements received on the filings, FINRA's responses to those comments and statements, the Petition for Review, and the comments and statements received in response to the Petition for Review—to determine whether the 2021 Amendments are consistent with the requirements of the Exchange Act and the rules and regulations thereunder, including that they do not impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.[42]

For the reasons discussed below, the Commission finds that FINRA has met its burden to show that the 2021 Amendments are consistent with the requirements of the Exchange Act and the applicable rules and regulations thereunder; including that they do not impose any burden on

---

40 See Petition for Review. Prior to the filing of the Petition for Review, the Petitioners timely filed a notice of their intent to file a petition.

41 See Exchange Act Release No. 94724 (Apr. 14, 2022), 87 FR 23287 (Apr. 19, 2022) ("2022 Scheduling Order").

42 See 15 U.S.C. 78*o*-3(b)(6) and (9).

competition not necessary or appropriate in furtherance of the purposes of the Act.[43] Consequently, the Commission is: (1) setting aside the Division's 2022 Approval Order approving the 2021 Amendments pursuant to delegated authority; and (2) approving the 2021 Amendments.

Finally, as discussed below, the 2021 Amendments were subject to notice and comment which provided multiple opportunities for interested parties to comment. The proposed rule change also included the institution of proceedings, which afforded interested parties additional opportunities and time to provide comments to the Commission. Consequently, the record for the 2021 Amendments includes numerous comments, and responses from FINRA to the comments.[44]

B. Procedural History and Background of Covered Agency Transaction Margin Requirements

1. The 2016 Amendments (SR-FINRA-2015-036)

On October 6, 2015, FINRA filed with the Commission, pursuant to Section 19(b)(1) of the Exchange Act[45] and Rule 19b-4 thereunder,[46] a proposed rule change to amend FINRA Rule 4210 to establish margin requirements for Covered Agency Transactions (i.e., the requirements that FINRA's broker-dealer members perform credit risk determinations and collect margin with respect to Covered Agency Transactions).[47] The proposed rule change was published for

43 See 15 U.S.C. 78*o*-3(b)(6) and (9).

44 See section I.B.2. of this order (discussing the procedural history of the 2021 Amendments).

45 15 U.S.C. 78s(b)(1).

46 17 CFR 240.19b-4.

47 See File No. SR-FINRA-2015-036. Certain documents related to this rule change are available on FINRA's website at: https://www.finra.org/rules-guidance/rule-filings/sr-finra-2015-036.

comment in the Federal Register on October 20, 2015.[48] On November 10, 2015, FINRA extended the time period in which the Commission must approve the proposed rule change, disapprove the proposed rule change, or institute proceedings to determine whether to approve or disapprove the proposed rule change to January 15, 2016.[49] The Commission received over 100 comment letters on the proposed amendments.[50]

On January 13, 2016, FINRA responded to the comments and filed Amendment No. 1 to the proposed rule change.[51] In response to comments, Amendment No. 1, among other things, excluded certain types of securities from the scope of the proposed margin requirements and set bifurcated implementation dates for when broker-dealers would need to begin complying with the amendments if the Commission approved them: six months with respect to the credit risk determination requirements and eighteen months with respect to the margin collection requirements.

On January 14, 2016, the Commission issued an order instituting proceedings pursuant to Section 19(b)(2)(B) of the Exchange Act[52] to determine whether to approve or disapprove the proposed rule change, as modified by Amendment No. 1.[53] The 2016 Order Instituting

---

48 See Exchange Act Release No. 76148 (Oct. 14, 2015), 80 FR 63603 (Oct. 20, 2015) (File No. SR-FINRA-2015-036).

49 See Letter to Katherine England, Assistant Director, Division, Commission from Adam Arkel. Associate General Counsel, Office of the General Counsel, FINRA (Nov. 10, 2015).

50 The public comment file for the proposed rule change is available at: https://www.sec.gov/comments/sr-finra-2015-036/finra2015036.shtml ("2016 Rulemaking Comment File"). The Commission staff also participated in numerous meetings and conference calls with certain commenters and other market participants, which are also noted in the 2016 Rulemaking Comment File.

51 See Amendment No. 1 to the proposed rule change (Jan. 13, 2016) ("Amendment No. 1").

52 15 U.S.C. 78s(b)(2)(B).

53 See Exchange Act Release No. 76908 (Jan. 14, 2016), 81 FR 3532 (Jan. 21, 2016) (Order Instituting Proceedings To Determine Whether To Approve or Disapprove Proposed Rule Change to Amend FINRA Rule 4210 (Margin Requirements) to Establish Margin Requirements for the TBA Market, as Modified by Partial Amendment No. 1) ("2016 Order Instituting Proceedings").

Proceedings was issued by the Division pursuant to delegated authority and was published in the Federal Register on January 21, 2016.[54] By instituting proceedings, the Commission extended by 90 days the date by which the Commission would need to approve or disapprove the proposed amendments and provided the opportunity for further extensions. The Commission received more than 20 comment letters in response to the 2016 Order Instituting Proceedings.[55] On March 21, 2016, FINRA responded to the comments and filed Amendment No. 2.[56] The amendment, among other things, clarified certain text of the proposed rule.

On April 15, 2016, notice of Amendment No. 2 to the proposed rule change was published in the Federal Register to solicit comments from interested persons and to designate a longer period for Commission action on the proposed rule change: until June 16, 2016.[57] The Commission received nine additional comment letters in response to the Amendment No. 2 Notice.[58] On May 26, 2016, FINRA responded to the comments and filed Amendment No. 3.[59] Amendment No. 3 expanded the applicability of an exception under which the broker-dealer would not need to collect margin from counterparties with limited Covered Agency Transactions. In particular, the amendment applied the exception to counterparties with $10 million or less in gross open Covered Agency Transactions instead of a lower threshold of $2.5 million or less, as originally proposed.

---

54 Id.

55 See 2016 Rulemaking Comment File.

56 See Amendment No. 2 to the proposed rule change (Mar. 21, 2016) ("Amendment No. 2").

57 See Exchange Act Release No. 77579 (Apr. 11, 2016), 81 FR 22347 (Apr. 15, 2016) (Notice of Filing of Amendment No. 2 and Designation of a Longer Period for Commission Action on Proceedings to Determine Whether to Approve or Disapprove Proposed Rule Change to Amend FINRA Rule 4210 (Margin Requirements) to Establish Margin Requirements for the TBA Market, as Modified by Amendment Nos. 1 and 2) ("Amendment No. 2 Notice").

58 See 2016 Rulemaking Comment File.

59 See Amendment No. 3 to the proposed rule change (May 26, 2016) ("Amendment No. 3").

On June 21, 2016, a notice and order was published in the Federal Register to solicit comment on Amendment No. 3 and approve the proposed rule change, as modified by Amendment Nos. 1, 2, and 3 on an accelerated basis (i.e., approve the 2016 Amendments).[60] The Division issued the 2016 Approval Order pursuant to delegated authority. The Commission did not receive any comments in response to the notice of Amendment No. 3. Further, no petition was filed with the Commission to review the Division's action approving the 2016 Amendments by delegated authority. The effective date for the requirement to perform credit risk determinations under the 2016 Amendments was December 15, 2016. The effective date for the margin collection requirements for Covered Agency Transactions under the 2016 Amendments is October 25, 2023.[61]

2. The 2021 Amendments (SR-FINRA-2021-010)

On May 7, 2021, FINRA filed with the Commission, pursuant to Section 19(b)(1) of the Exchange Act[62] and Rule 19b-4 thereunder,[63] a proposed rule change to amend the margin requirements for Covered Agency Transactions under Rule 4210.[64] The proposed rule change would: (1) eliminate the two percent maintenance margin requirement that applies to non-exempt accounts; (2) subject to specified conditions and limitations, permit members to take a capital charge in lieu of collecting margin for excess net mark to market losses on Covered Agency Transactions; and (3) make revisions designed to streamline, consolidate and clarify the Covered

60 2016 Approval Order.

61 See Exchange Act Release No. 97062 (Mar. 7, 2023), 88 FR 15473 (Mar. 13, 2023) (File No. SR-FINRA-2023-002) (extending the implementation date of the margin collection requirements under SR-FINRA-2015-036 from April 24, 2023 to October 25, 2023).

62 15 U.S.C. 78s(b)(1).

63 17 CFR 240.19b-4.

64 The full text of the proposed rule change and the exhibits FINRA filed are collectively referred to as the "proposal," and are available at: https://www.finra.org/rules-guidance/rule-filings/sr-finra-2021-010.

Agency Transaction rule language. The proposed rule change was published for comment in the Federal Register on May 25, 2021.[65] On June 30, 2021, FINRA extended the time period in which the Commission must approve the proposed rule change, disapprove the proposed rule change, or institute proceedings to determine whether to approve or disapprove the proposed rule change to August 23, 2021.[66] The Commission received five comment letters in response to the proposed rule change.[67]

On August 9, 2021, FINRA responded to the comments and filed Amendment No. 1 (2021) to the proposed rule change.[68] In response to comments, Amendment No. 1 (2021), among other things, would: (1) modify the definition of "non-margin counterparty" to exclude small cash counterparties and other exempted counterparties; (2) define a FINRA member's "specified net capital deductions" as the net capital deductions required by paragraph (e)(2)(H)(ii)d.1. of FINRA Rule 4210 with respect to all unmargined excess net mark to market losses of its counterparties, except to the extent that the member, in good faith, expects such excess net mark to market losses to be margined by the close of business on the fifth business day after they arose; and (3) set an implementation date for the Amended Margin Collection Requirements.[69]

---

65 See Notice.

66 See Letter from Adam Arkel, Associate General Counsel, Office of General Counsel, FINRA, to Sheila Swartz, Division, Commission (June 30, 2021).

67 The public comment file for the proposed rule change is published on the Commission's website at: https://www.sec.gov/comments/sr-finra-2021-010/srfinra2021010.htm ("2021 Rulemaking Comment File").

68 See Amendment No. 1 to the proposed rule change (Aug. 9, 2021) ("Amendment No. 1 (2021)").

69 See Amendment No. 1 (2021).

On August 20, 2021, the Commission issued an order instituting proceedings pursuant to Section 19(b)(2)(B) of the Exchange Act[70] to determine whether to approve or disapprove the proposed rule change, as modified by Amendment No. 1 (2021).[71] The 2021 Order Instituting Proceedings was issued by the Division pursuant to delegated authority and was published in the Federal Register on August 26, 2021.[72] The Commission received two comment letters in response to the 2021 Order Instituting Proceedings.[73] On September 16, 2021, FINRA responded to the comments received in response to the 2021 Order Instituting Proceedings.[74] On October 26, 2021, FINRA extended the time period in which the Commission must approve or disapprove the proposed rule change to January 20, 2022.[75]

On January 20, 2022, the Division, acting pursuant to delegated authority on behalf of the Commission,[76] approved the proposed rule change, as modified by Amendment No. 1 (2021).[77] On January 27, 2022, the BDA and Brean Capital—the "Petitioners"—filed a notice of intention to petition for review of the 2022 Approval Order.[78] Pursuant to the Commission's Rules of Practice 431(e), the 2022 Approval Order was stayed by the filing with the Commission of a

---

70 15 U.S.C. 78s(b)(2)(B).

71 See Exchange Act Release No. 92713 (Aug. 20, 2021), 86 FR 47655 (Aug. 26, 2021) ("2021 Order Instituting Proceedings").

72 Id.

73 See 2021 Rulemaking Comment File.

74 See Letter from Adam Arkel, Associate General Counsel, Office of General Counsel, FINRA, to Vanessa Countryman, Commission (Sept. 16, 2021) ("FINRA Letter").

75 See Letter from Adam Arkel, Associate General Counsel, Office of General Counsel, FINRA, to Sheila Swartz, Division, Commission (Oct. 26, 2021).

76 17 CFR 200.30-3(a)(12).

77 See 2022 Approval Order.

78 See Notice of Intention to Petition for Review of Order Granting Approval of 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, Release No. 34-94013; File No. SR-FINRA-2021-010, available at https://www.sec.gov/rules/sro/finra/2022/34-94013-petn-cooper-kirk.pdf.

notice of intention to petition for review.[79] On February 3, 2022, the Petitioners jointly filed a timely Petition for Review.[80] On April 14, 2022, the Commission issued a scheduling order, pursuant to Commission's Rules of Practice, granting the Petition for Review of the 2022 Approval Order and providing until May 10, 2022 for any party or other person to file a written statement in support of, or in opposition to, the 2022 Approval Order.[81] The scheduling order also stated that the proposed rule change, as modified by Amendment No. 1 (2021), shall remain stayed pending further Commission action.[82] On May 10, 2022, FINRA submitted a written statement in support of the 2022 Approval Order.[83] On May 10, 2022, the Petitioners submitted a written statement in opposition to the 2022 Approval Order.[84] The Commission also received over ten additional statements from market participants in response to the Petition for Review.[85]

II. How the 2021 Amendments Would Change the Covered Agency Transaction Margin Requirements of Rule 4210

A. Elimination of the Two Percent Maintenance Margin Requirement

Under the 2016 Amendments, Rule 4210 imposes different margin requirements for accounts that are "exempt accounts" and accounts that are not "exempt accounts." Accounts that

---

79 17 CFR 201.431(e).

80 See Petition for Review.

81 See 2022 Scheduling Order.

82 Id.

83 See FINRA's Statement in Support of Proposed Rule Change to Amend the Requirements for Covered Agency Transactions Under FINRA Rule 4210 (File No. SR-FINRA-2021-010) ("FINRA Statement").

84 See Petitioners' Statement in Opposition to Approval of the Proposed Rule Change ("Petitioners' Statement").

85 See 2021 Rulemaking Comment File. Weichert Financial Services submitted six nearly identical letters signed by different individuals. See Letters from Nancy Crocetto, SVP, Mortgage Operations (May 9, 2022); Eric Declercq, President (May 9, 2022); James M. Weichert, President & Chief Executive Officer (May 9, 2022); Anthony P. Fattizzi, Chief Risk Officer (May 4, 2022); Michael Cadematori (May 4, 2022); Timothy McLaughlin, Chief Investment Officer (May 3, 2022). These are collectively considered one comment letter and referred to as the "Weichert Letters."

are not "exempt accounts" under the 2016 Amendments are subject to stricter margin requirements than "exempt accounts" because the broker-dealer is required to collect two percent maintenance margin with respect to these accounts in addition to margin to cover the counterparty's mark to market loss.[86] In particular, paragraph (e)(2)(H)(ii)e. of Rule 4210 broadly provides that the broker-dealer must collect margin from counterparties that are non-exempt accounts equal to the maintenance margin amount, defined to mean margin equal to two percent of the contract value of the net long or net short position, by CUSIP, with the counterparty, plus any net mark to market loss, subject to specified exceptions under the rule.[87] By contrast, under the 2016 Amendments, paragraph (e)(2)(H)(ii)d. of Rule 4210 broadly provides that the broker-dealer must collect margin from counterparties that are exempt accounts

---

86 The term "exempt account" is defined under FINRA Rule 4210(a)(13). Broadly, an exempt account means a FINRA member, a non-FINRA member registered broker-dealer, an account that is a "designated account" under FINRA Rule 4210(a)(4) (specifically, a bank as defined under Section 3(a)(6) of the Exchange Act, a savings association as defined under Section 3(b) of the Federal Deposit Insurance Act, the deposits of which are insured by the Federal Deposit Insurance Corporation, an insurance company as defined under Section 2(a)(17) of the Investment Company Act, an investment company registered with the Commission under the Investment Company Act, a state or political subdivision thereof, or a pension plan or profit sharing plan subject to the Employee Retirement Income Security Act or of an agency of the United States or of a state or political subdivision thereof), and any person that has a net worth of at least $45 million and financial assets of at least $40 million for purposes of paragraphs (e)(2)(F), (e)(2)(G) and (e)(2)(H) of FINRA Rule 4210, as set forth under paragraph (a)(13)(B)(i) of FINRA Rule 4210, and meets specified conditions as set forth under paragraph (a)(13)(B)(ii). See Notice, 86 FR at 28163, n.18. Unless otherwise noted, references to the 2016 Amendments are to the "current rule" or "original rulemaking."

87 See 2016 Approval Order, 81 FR at 40367; see also paragraph (e)(2)(H)(ii)e. of the current rule in Exhibit 5. The rule further sets forth specified requirements for net capital deductions and the liquidation of positions in the event the uncollected maintenance margin and mark to market loss (defined together under paragraph (e)(2)(H)(i)d. of the current rule as the "deficiency") is not satisfied. In short, the rule provides that if the deficiency is not satisfied by the close of business on the next business day after the business day on which the deficiency arises, the member shall be required to deduct the amount of the deficiency from net capital as provided in Exchange Act Rule 15c3-1 until such time the deficiency is satisfied; under the rule, if such deficiency is not satisfied within five business days from the date the deficiency was created, the member must promptly liquidate positions to satisfy the deficiency, unless FINRA has specifically granted the member additional time. As discussed in further detail below, the proposed rule change would eliminate current paragraph (e)(2)(H)(ii)e. in its entirety.

equal to any net mark to market loss, subject to specified exceptions under the rule (i.e., maintenance margin need not be collected).[88]

In connection with the 2021 Amendments, FINRA stated that broker-dealer members expressed concern that the different treatment of exempt and non-exempt accounts is burdensome because members will be obligated to obtain and assess the financial information needed to determine which counterparties must be treated as non-exempt accounts.[89] Further, based on feedback from members since the approval date of the 2016 Amendments and additional observation of market conditions, FINRA stated it now believes that the potential risk that the maintenance margin requirement was intended to address when originally proposed is not significant enough to warrant the burdens and competitive disadvantage that the requirement imposes.[90] According to FINRA, members pointed out that, in practice, the maintenance margin requirement would apply to relatively few accounts of entities that participate in the Covered Agency Transaction market. Further, FINRA stated that monitoring and collecting maintenance margin for these accounts will be operationally burdensome and out of proportion with the number and size of the affected accounts.[91] Further, according to FINRA, bank dealers are not

---

88 See 2016 Approval Order, 81 FR at 40367; see also paragraph (e)(2)(H)(ii)d. of the current rule in Exhibit 5 to the 2016 Amendments. Similar to paragraph (e)(2)(H)(ii)e., current paragraph (e)(2)(H)(ii)d. provides that if the mark to market loss is not satisfied by the close of business on the next business day after the business day on which the mark to market loss arises, the member is required to deduct the amount of the mark to market loss from net capital as provided in Exchange Act Rule 15c3-1 until such time the mark to market loss is satisfied; if such mark to market loss is not satisfied within five business days from the date the loss was created, the member must promptly liquidate positions to satisfy the mark to market loss, unless FINRA has specifically granted the member additional time. Again, as discussed in further detail below, the proposed rule change would eliminate current paragraph (e)(2)(H)(ii)d. in its entirety.

89 See Notice, 86 FR at 28163. Further, FINRA stated that members expressed concern that some asset manager counterparties face constraints with regard to custody of assets at broker-dealers and that, because of these constraints, some members need to enter into separate custodial agreements with third party banks to hold the maintenance margin that they collect from these asset managers. Members expressed concern that this imposes operational burdens both on themselves and their client counterparties, who may, as a consequence, choose to limit their dealings with smaller broker-dealers. Id. at n.23.

90 See Notice, 86 FR at 28163.

91 Id.

subject to the requirement to collect maintenance margin from their customers, which would significantly disadvantage broker-dealers that compete with bank dealers.[92] To address these concerns, FINRA proposed to eliminate paragraphs (e)(2)(H)(ii)d. and (e)(2)(H)(ii)e. of Rule 4210, and replace them with new paragraph (e)(2)(H)(ii)c. This paragraph would provide that FINRA's broker-dealer members must collect margin for each counterparty's[93] excess net mark to market loss,[94] unless otherwise provided under proposed new paragraph (e)(2)(H)(ii)d. of the

---

92 Id.

93 Current paragraph (e)(2)(H)(i)b. defines the term "counterparty" to mean any person that enters into a Covered Agency Transaction with a member and includes a "customer" as defined in paragraph (a)(3) under FINRA Rule 4210. The proposed rule change would redesignate the definition of counterparty as paragraph (e)(2)(H)(i)a. under the rule and revise the definition to provide that the term "counterparty" means any person, including any "customer" as defined in paragraph (a)(3) of the rule, that is a party to a Covered Agency Transaction with, or guaranteed by, a member. FINRA believes that including transactions guaranteed by a member is a useful clarifying change in the context of Covered Agency Transactions. In connection with this change, FINRA proposes to add new Supplemental Material .02, which would provide that, for purposes of paragraph (e)(2)(H), a member is deemed to have "guaranteed" a transaction if the member has become liable for the performance of either party's obligations under the transaction. See proposed new Supplemental Material .02 in Exhibit 5 to the proposal. Accordingly, if a clearing broker were to guarantee to an introduced customer an introducing broker's obligations under a Covered Agency Transaction between that introducing firm and customer, the introducing broker would be considered a "counterparty" of the clearing broker for purposes of paragraph (e)(2)(H). See also Notice, 86 FR at 28163-64, n.25.

94 FINRA proposes to delete the current definition of "mark to market loss" under paragraph (e)(2)(H)(i)g. as adopted pursuant to the 2016 Approval Order and to replace it with a definition of "net mark to market loss" under proposed new paragraph (e)(2)(H)(i)d. Under the new definition, a counterparty's "net mark to market loss" would mean (1) the sum of such counterparty's losses, if any, resulting from marking to market the counterparty's Covered Agency Transactions with the member, or guaranteed to a third party by the member, reduced to the extent of the member's legally enforceable right of offset or security by (2) the sum of such counterparty's gains, if any, resulting from: (a) marking to market the counterparty's Covered Agency Transactions with the member, guaranteed to the counterparty by the member, cleared by the member through a registered clearing agency, or in which the member has a first-priority perfected security interest; and (b) any "in the money," as defined in paragraph (f)(2)(E)(iii) of FINRA Rule 4210, amounts of the counterparty's long standby transactions written by the member, guaranteed to the counterparty by the member, cleared by the member through a registered clearing agency, or in which the member has a first-priority perfected security interest. Under proposed new paragraph (e)(2)(H)(i)c., a counterparty's "excess" net mark to market loss is defined to mean such counterparty's net mark to market loss to the extent it exceeds $250,000. As such, by specifying excess net mark to market loss, FINRA stated that the proposed rule preserves the $250,000 de minimis transfer exception set forth under paragraph (e)(2)(H)(ii)f. as adopted pursuant to the 2016 Approval Order. Further, FINRA stated that, in the interest of clarity, proposed new paragraph (e)(2)(H)(ii)c. expressly provides that members would not be required to collect margin, or take capital charges, for counterparties' mark to market losses on Covered Agency Transactions other than excess net mark to market losses. Last, as discussed further below, the proposed rule change would delete paragraph (e)(2)(H)(ii)f. in the interest of consolidating the rule language. See Notice, 86 FR at 28164, n.26.

rule, as discussed further below. As such, both exempt and non-exempt accounts would receive the same margin treatment for purposes of Covered Agency Transactions under paragraph (e)(2)(H).[95] In particular, under the amendments, FINRA's broker-dealer members would not be required to collect the two percent maintenance margin amount for non-exempt accounts.

B. Option for Capital Charge in Lieu of Mark to Market Margin

The 2021 Amendments would add new paragraph (e)(2)(H)(ii)d. to Rule 4210.[96] This paragraph would provide FINRA's broker-dealer members, subject to specified conditions and limitations, the option to take a capital charge in lieu of collecting margin for a counterparty's excess net mark to market loss (that is, the net mark to market loss to the extent it exceeds $250,000). Informed by FINRA's engagement with members, FINRA believes this approach is appropriate because it would help alleviate the competitive disadvantage of smaller firms vis-à-vis larger firms. FINRA stated smaller firms expressed concern that larger firms can leverage their greater size and scale in obtaining margining agreements with their counterparties, and that counterparties would prefer to transact with larger firms with which margining agreements can more readily be obtained, or with banks that are not subject to margin requirements. FINRA also stated that smaller firms told FINRA that having the option to take a capital charge, in lieu of collecting margin, would help alleviate the competitive disadvantage of needing to obtain margining agreements with such counterparties because there would be an alternative to collecting margin.[97] To this end, as stated above, the proposed rule change includes conditions

---

95 Current paragraph (e)(2)(H)(ii)d. of the rule contains provisions designed to permit members to treat mortgage bankers, as defined pursuant to current paragraph (e)(2)(H)(i)h. of the rule, as exempt accounts under specified conditions. Because the proposed rule change eliminates the distinction between exempt and non-exempt accounts for purposes of Covered Agency Transactions, FINRA believes this language is no longer needed and proposed deleting this language. See Notice, 86 FR at 28164, n.27.

96 See Notice, 86 FR at 28164.

97 See Notice, 86 FR at 28164; see also FINRA Statement at 25 (citing Letter from Michael Nicholas, Chief

and limitations that FINRA stated 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 to compete unfairly with smaller members.[98] Specifically, the proposed new paragraph provides that a member need not collect margin for a counterparty's excess net mark to market loss under paragraph (e)(2)(H)(ii)c. of the rule, provided that:

- The member must deduct the amount of the counterparty's unmargined excess net mark to market loss from the member's net capital computed as provided in Exchange Act Rule 15c3-1, if the counterparty is a non-margin counterparty[99] or if the excess net mark to market loss has not been margined or eliminated by the close of business on the next business day after the business day on which such excess net mark to market loss arises;[100]
- If the member has any non-margin counterparties, the member must 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 proposed to be revised pursuant to this proposed rule change,[101] and that the member's net capital

---

Executive Officer, BDA to Ms. Kris Dailey Vice President, Risk Oversight & Operational Regulation, FINRA (June 7, 2018) at 1-2 ("BDA 2018 Letter"), available at http://d31hzlhk6di2h5.cloudfront.net/20180607/81/e8/1f/28/96174e7b8c13fad4d07fa8aa/BDA_4210_Capital_Charge_.pdf).

98 See Notice, 86 FR at 28164.

99 Proposed new paragraph (e)(2)(H)(i)e. defines a counterparty as a "non-margin counterparty" if the member: (1) does not have a right under a written agreement or otherwise to collect margin for such counterparty's excess net mark to market loss and to liquidate such counterparty's Covered Agency Transactions if any such excess net mark to market loss is not margined or eliminated within five business days from the date it arises; or (2) does not regularly collect margin for such counterparty's excess net mark to market loss. See Amendment No. 1 (2021); see also section II.D. below for a discussion of modification to proposed definition of non-margin counterparty.

100 See proposed paragraph (e)(2)(H)(ii)d.1. in Exhibit 5 to the proposal.

101 Current paragraph (e)(2)(I) sets forth specified concentration thresholds. As discussed further below in section II.C, the rule change would make conforming revisions to the rule.

deductions under proposed paragraph (e)(2)(H)(ii)d.1. of the rule for all accounts combined will not exceed $25 million;[102]

- If the member's net capital deductions under paragraph (e)(2)(H)(ii)d.1. of the rule for all accounts combined exceed $25 million for five consecutive business days, the member must give prompt written notice to FINRA. If the member's net capital deductions under paragraph (e)(2)(H)(ii)d.1. of the rule for all accounts combined exceed the lesser of $30 million or 25% of the member's tentative net capital,[103] as such term is defined in Exchange Act Rule 15c3-1, for five consecutive business days, the member may not enter into any new Covered Agency Transactions with any non-margin counterparty other than risk-reducing transactions, and must also, to the extent of its rights, promptly collect margin for each counterparty's excess net mark to market loss and promptly liquidate the Covered Agency transactions of any counterparty whose excess net mark to market loss is not margined or eliminated within five business days from the date it arises, unless FINRA has specifically granted the member additional time;[104] and
- The member must submit to FINRA such information regarding its unmargined net mark to market losses, non-margin counterparties and related capital charges, in such form and manner, as FINRA shall prescribe by Regulatory Notice or similar communication.[105]

C. Streamlining and Consolidation of Rule Language; Conforming Revisions

In support of the amendments discussed above, FINRA has proposed several amendments to the current rule designed to streamline and consolidate the rule language and

---

102 See proposed paragraph (e)(2)(H)(ii)d.2. in Exhibit 5 to the proposal.

103 This is referred to collectively as the 25% TNC / $30MM Threshold for purposes of this order.

104 See proposed paragraph (e)(2)(H)(ii)d.3. in Exhibit 5 to the proposal.

105 See Notice, 86 FR at 28164. See also proposed paragraph (e)(2)(H)(ii)d.4. in Exhibit 5 to the proposal.

otherwise make conforming revisions. Generally, these amendments are intended to, among other things: (1) consolidate language related to certain exceptions regarding the de minimis transfer amount and $10 million gross open position amount and introduce the term "small cash counterparty"; (2) remove defined terms that are no longer relevant; (3) conform and consolidate language related to excepted counterparties and risk limits; (4) revise existing rule text to reflect the elimination of the two percent maintenance margin requirement; and (5) revise related supplemental material to conform to the proposed rule changes. These proposed changes are described in greater detail below.

- The proposed rule change would consolidate language related to the $250,000 de minimis transfer exception and the $10 million gross open position exception while, as discussed above, preserving these exceptions in substance. FINRA stated that the $250,000 de minimis transfer exception is preserved because paragraph (e)(2)(H)(ii)c. under the revised rule specifies that the members shall collect margin for each counterparty's excess net mark to margin loss, unless otherwise provided under paragraph (e)(2)(H)(ii)d. of the rule (that is, the provisions under the proposed rule change that permit a member to take a capital charge in lieu of collecting margin, subject to specified conditions).[106] The proposed rule change deletes paragraph (e)(2)(H)(ii)f., which currently addresses the de minimis exception and would be rendered redundant by the rule change. With respect to the current $10 million gross open position exception, FINRA proposes to revise paragraph (e)(2)(H)(ii)a. of the rule, which identifies the types of counterparties that are excepted from the rule's margin requirements, to include a "small cash counterparty."

[106] See Notice, 86 FR at 28165.

Proposed new paragraph (e)(2)(H)(i)h. would provide that a counterparty is a "small cash counterparty" if:

- The absolute dollar value of all of such counterparty's open Covered Agency Transactions with, or guaranteed by, the member is $10 million or less in the aggregate, when computed net of any settled position of the counterparty held at the member that is deliverable under such open Covered Agency Transactions and which the counterparty intends to deliver;[107]
- The original contractual settlement date for all such open Covered Agency Transactions is in the month of the trade date for such transactions or in the month succeeding the trade date for such transactions;[108]
- The counterparty regularly settles its Covered Agency Transactions on a delivery-versus-payment ("DVP") basis or for cash;[109] and
- The counterparty does not, in connection with its Covered Agency Transactions with, or guaranteed by, the member, engage in dollar rolls, as defined in Rule 6710(z), or round robin trades,[110] or use other financing techniques.[111]

The above elements, according to FINRA, are substantially similar to the elements that are currently associated with the exception as set forth under current paragraph

---

107 See proposed paragraph (e)(2)(H)(i)h.1. in Exhibit 5 to the proposal.

108 See proposed paragraph (e)(2)(H)(i)h.2. in Exhibit 5 to the proposal.

109 See proposed paragraph (e)(2)(H)(i)h.3. in Exhibit 5 to the proposal.

110 The term "round robin" is defined under current paragraph (e)(2)(H)(i)i. of the rule and, pursuant to the rule change, would be redesignated as paragraph (e)(2)(H)(i)g., without any change.

111 See proposed paragraph (e)(2)(H)(i)h.4. in Exhibit 5 to the proposal.

(e)(2)(H)(ii)c.2., which would be deleted, along with the definition of "gross open position" under paragraph (e)(2)(H)(i)e., which would be rendered redundant by the rule change.[112] The new proposed language reflects that the scope of transactions addressed by the rule include Covered Agency Transactions with a counterparty that are guaranteed by the member.

- FINRA proposes to delete the definition of "bilateral transaction" set forth in current paragraph (e)(2)(H)(i)a. The definition is used in connection with the provisions under the current rule relating to margin treatment for exempt accounts under paragraph (e)(2)(H)(ii)d. and for non-exempt accounts under paragraph (e)(2)(H)(ii)e., both of which paragraphs, as discussed above, FINRA proposes to delete pursuant to the rule change. Further, FINRA states that the term "bilateral transaction" is unduly narrow given that the proposed revised definition of "counterparty" would have the effect of clarifying that the rule's scope includes transactions guaranteed by the member.[113]
- FINRA proposes to delete the definition of the term "deficiency" set forth in current paragraph (e)(2)(H)(i)d. Under the current rule, the term is designed in part to reference required but uncollected maintenance margin for Covered Agency Transactions. Because the rule change proposes to eliminate the maintenance margin requirement, FINRA believes that the term is not needed.[114]
- Current paragraph (e)(2)(H)(ii)a. addresses the scope of paragraph (e)(2)(H) and certain types of counterparties that are excepted from the rule, provided the member makes and

---

112 See Notice, 86 FR at 28165.

113 See Notice, 86 FR at 28165.

114 See Notice, 86 FR at 28165.

enforces written risk limits pursuant to paragraph (e)(2)(H)(ii)b. Current paragraph (e)(2)(H)(ii)b. contains the core language under the rule relating to risk limits. FINRA is proposing to revise both paragraphs to conform with the changes proposed in the 2021 Amendments and consolidate the language relating to written risk limits in these paragraphs within paragraph (e)(2)(H)(ii)b. Paragraph (e)(2)(H)(ii)a.1. would be revised to read: "1. a member is not required to collect margin, or to take capital charges in lieu of collecting such margin, for a counterparty's excess net mark to market loss if such counterparty is a small cash counterparty, registered clearing agency, 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 for International Settlements; and . . ."[115] Paragraph (e)(2)(H)(ii)a.2. would be revised to read: "2. a member is not required to include a counterparty's Covered Agency Transactions in multifamily housing securities or project loan program securities in the computation of such counterparty's net mark to market loss, provided . . ."[116] Paragraph (e)(2)(H)(ii)a.2.A. would not be changed, other than to be redesignated as paragraph (e)(2)(H)(ii)a.2. Paragraph

---

115 The proposed language in the paragraph reflects FINRA's proposed establishment of the option to take a net capital charge in lieu of collecting margin. Further, FINRA stated that, for clarity, the proposed rule change adds registered clearing agencies to the types of counterparties that are within the exception pursuant to paragraph (e)(2)(H)(ii)a. as revised. FINRA believes that this preserves the treatment of registered clearing agencies under the rule in light of the proposed deletion of current paragraph (e)(2)(H)(ii)c. In this regard, also in the interest of clarity, FINRA proposes to add new paragraph (e)(2)(H)(i)f. defining the term "registered clearing agency." See Notice, 86 FR at 28165, n.39.

116 Under current paragraph (e)(2)(H)(ii)a.2., a member is not required to apply the margin requirements of paragraph (e)(2)(H) to Covered Agency Transactions with a counterparty in multifamily housing securities or project loan program securities, provided the securities meet the specified conditions under the rule and the member makes and enforces the written risk limit determinations as specified under the rule. FINRA stated that the proposed rule change does not change the treatment of multifamily housing securities or project loan program securities under the current rule other than to clarify, in express terms, that a member is not required to include a counterparty's Covered Agency Transactions in multifamily housing securities or project loan program securities in the computation of such counterparty's net mark to market loss. See Notice, 86 FR at 28165, n.40.

(e)(2)(H)(ii)a.2.B. would be eliminated as redundant[117] because, correspondingly, paragraph (e)(2)(H)(ii)b. would be revised to read: "A member that engages in Covered Agency Transactions with any counterparty shall make a determination in writing of a risk limit for each such counterparty, including any counterparty specified in paragraph (e)(2)(H)(ii)a.1. of this Rule, that the member shall enforce. The risk limit for a counterparty shall cover all of the counterparty's Covered Agency Transactions with the member or guaranteed to a third party by the member, including Covered Agency Transactions specified in paragraph (e)(2)(H)(ii)a.2. of this Rule. The risk limit determination shall be made by a designated credit risk officer or credit risk committee in accordance with the member's written risk policies and procedures."[118]

- Paragraph (e)(2)(I) under FINRA Rule 4210 addresses concentration thresholds. FINRA is proposing to make revisions to align the paragraph with the proposed new language of paragraph (e)(2)(H), in particular the elimination of the maintenance margin requirement and the introduction of the proposed new term "small cash counterparty." Specifically, FINRA proposes to revise the opening sentence of paragraph (e)(2)(I) to read: "In the event that (i) the net capital deductions taken by a member as a result of marked to the market losses incurred under paragraphs (e)(2)(F), (e)(2)(G) (exclusive of the percentage requirements established thereunder), or (e)(2)(H)(ii)d.1. of this Rule, plus any unmargined net mark to market losses below $250,000 or of small cash counterparties exceed . . ."[119] Current paragraph (e)(2)(I)(i)c. would be redesignated as (e)(2)(I)(ii) and would read: "(ii) such excess as calculated in paragraph (e)(2)(I)(i) of this Rule continues

117 See proposed paragraph (e)(2)(H)(ii)a. in Exhibit 5 to the proposal.

118 See proposed paragraph (e)(2)(H)(ii)b. in Exhibit 5 to the proposal.

119 See proposed paragraph (e)(2)(I) in Exhibit 5 to the proposal.

to exist on the fifth business day after it was incurred. . ." The final clause of the paragraph would be revised to read: ". . . the member shall give prompt written notice to FINRA and shall not enter into any new transaction(s) subject to the provisions of paragraphs (e)(2)(F), (e)(2)(G) or (e)(2)(H) of this Rule that would result in an increase in the amount of such excess."

- Paragraph (f)(6) under FINRA Rule 4210 addresses the time within which margin or "mark to market" must be obtained. FINRA proposes to delete the phrase "other than that required under paragraph (e)(2)(H) of this Rule," so the rule, as revised, would read: "The amount of margin or 'mark to market' required by any provision of this Rule shall be obtained as promptly as possible and in any event within 15 business days from the date such deficiency occurred, unless FINRA has specifically granted the member additional time." FINRA believes this is appropriate given the proposed elimination of current paragraph (e)(2)(H)(ii)d. and paragraph (e)(2)(H)(ii)e. of the rule, both of which set forth, among other things, specified time frames for collection of mark to market losses or deficiencies, as appropriate, and liquidation of positions that are specific to Covered Agency Transactions.[120]
- Current Supplemental Material .02 addresses the requirement to establish monitoring procedures with respect to mortgage bankers, for purposes of treating them as exempt accounts pursuant to current paragraph (e)(2)(H)(ii)d. Current Supplemental Material .03 addresses how the cure of mark to market loss or deficiency, as the term mark to market loss or deficiency is defined under the current rule, may eliminate the need to liquidate positions. Current Supplemental Material .04 addresses determining whether an account

[120] See Notice, 86 FR at 28166.

qualifies as an exempt account. The proposed rule change would render each of these provisions unnecessary, given that the proposed rule change would eliminate the need to distinguish exempt versus non-exempt accounts (including the language targeted toward mortgage bankers) and eliminates the liquidation provisions under current paragraph (e)(2)(H)(ii)d. and paragraph (e)(2)(H)(ii)e. of the rule.[121] FINRA proposes to redesignate current Supplemental Material .05 as Supplemental Material .03.[122]

Subject to Commission approval of the proposed rule change, FINRA proposed it would announce the effective date of the proposed rule change in a Regulatory Notice to be published no later than 60 days following Commission approval. FINRA stated that the effective date will be no later than 120 days following publication of the Regulatory Notice announcing Commission approval.[123]

D. Amendment No. 1 (2021)

In Amendment No. 1 (2021) to the proposed rule change, FINRA proposed to: (1) modify the definition of "non-margin counterparty" to exclude small cash counterparties and other exempted counterparties; and (2) define a FINRA member's "specified net capital deductions" as the net capital deductions required by paragraph (e)(2)(H)(ii)d.1. of FINRA Rule 4210 with respect to all unmargined excess net mark to market losses of its counterparties, except to the extent that the member, in good faith, expects such excess net mark to market losses to be

---

121 See Notice, 86 FR at 28166.

122 See Supplemental Material provisions in Exhibit 5 to the proposal.

123 See discussion of Amendment No. 1 (2021) in section III.E. below regarding the proposed adjustment of the implementation date. See also Amendment No. 1 (2021) at 20. FINRA stated that the proposed rule change would not impact members that are funding portals or that have elected to be treated as capital acquisition brokers, given that such members are not subject to FINRA Rule 4210. See Notice, 86 FR at 28166, n.45. The term "funding portal" is defined in Rule 100(b)(5) of FINRA's Funding Portal Rules. The term "capital acquisition broker" is defined in Rule 016(c) of FINRA's Capital Acquisition Broker Rules.

margined by the close of business on the fifth business day after they arose.[124] In addition, Amendment No. 1 (2021) states that, if the Commission approves the proposed rule change, as modified by Amendment No. 1 (2021), FINRA will announce the effective date of the proposed rule change, as modified by Amendment No. 1 (2021), in a Regulatory Notice to be published no later than 60 days following Commission approval. The effective date would be between nine and ten months following the Commission's approval.[125]

III. Commission Discussion and Findings

After careful review of the proposed rule change, as modified by Amendment No. 1 (2021), comment letters, FINRA's responses to the comments, the Petition for Review, and the statements received in response to the Petition for Review, as discussed below, the Commission finds that the proposed rule change, as modified by Amendment No. 1 (2021), is consistent with the requirements of the Exchange Act and the rules and regulations thereunder applicable to a national securities association.[126] Specifically, for the reasons discussed below, the Commission finds that the proposed rule change, as modified by Amendment No. 1 (2021), is consistent with Section 15A(b)(6) of the Exchange Act,[127] which requires, among other things, that FINRA rules be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to facilitate transactions in securities, to remove impediments to and

---

124 Amendment No. 1 (2021) also contains several conforming changes to paragraph numbering to accommodate the proposed modifications to the rule text. See Exhibit 4 to Amendment No. 1 (2021).

125 See Amendment No. 1 (2021); 2021 Order Instituting Proceedings, 86 FR at 47665.

126 In approving this rule change, the Commission has considered the rule's impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f). See, e.g., section III.A. (discussing alleviation of competitive impacts on broker-dealers with the elimination of the two percent maintenance margin requirement for non-exempt accounts and the option to take a capital charge in lieu of collecting the excess net mark to market loss, subject to a cap; competitive concerns raised by commenters regarding smaller firms exiting the market resulting in a concentration of larger firms; and enhancements in efficiency in streamlining and consolidating the rule text).

127 15 U.S.C. 78*o*-3(b)(6).

perfect the mechanism of a free and open market and, in general, to protect investors and the public interest. The Commission also finds that the proposed rule change, as modified by Amendment No. 1 (2021), is consistent with Section 15A(b)(9) of the Exchange Act,[128] which requires that the rules of a national securities association must not impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.

A. The Elimination of the Two Percent Maintenance Margin Requirement, the Optional Capital in Lieu of Margin Charge, and the Streamlining of the Rule Text are Consistent with the Exchange Act

1. Elimination of the Two Percent Maintenance Margin for Non-Exempt Accounts

a. Comments Received on the Proposal

As discussed in section II.A. above, FINRA proposed to eliminate the two percent maintenance margin requirement that would apply to non-exempt accounts under the current rule. The Commission received one comment supporting the proposed rule change to eliminate the two percent maintenance margin requirement for non-exempt accounts.[129]

b. FINRA's Rationale for the Proposed Change

FINRA stated that eliminating the two percent maintenance margin requirement for non-exempt accounts is intended to reduce costs for FINRA members and address any perceived competitive disadvantage between FINRA members and banks regarding Covered Agency Transactions. FINRA also stated that elimination of the two percent maintenance margin requirement will reduce costs and provide operational relief to FINRA members, as they will not need to enter into separate custodial arrangements with third-party banks to custody the

128 15 U.S.C. 78o-3(b)(9).

129 See Letter from Chris Killian, Managing Director, Securitization, Corporate Credit, Libor, Asset Management Group of SIFMA (June 15, 2021) ("SIFMA AMG Letter") at 1.

maintenance margin of counterparties that cannot deposit margin collateral directly with a broker-dealer.[130] By simplifying the current rule, mitigating concerns about regulatory compliance costs and allowing FINRA members to compete in the market more equally with non-FINRA members, FINRA stated that the elimination of the two percent maintenance margin requirement for non-exempt accounts promotes a more just and equitable market by promoting competition and efficiency, which will benefit investors and the public interest.[131]

c. Commission Discussion and Findings

The elimination of the two percent maintenance margin will reduce operational burdens and compliance costs for broker-dealers because they will no longer need to monitor which accounts are exempt or non-exempt for purposes of the Covered Agency Transaction margin requirements. In addition, the two percent maintenance margin requirement only would have applied to a small number of accounts. Monitoring which accounts are non-exempt accounts and collecting maintenance margin for these accounts is operationally burdensome and out of proportion with the number and size of the affected accounts. Elimination of the two percent maintenance margin requirement for non-exempt accounts also will alleviate competitive impacts for FINRA-member broker-dealers in comparison to banks that, depending on their size, may: (1) follow best practices of exchanging variation margin recommended by the Treasury Markets Practice Group ("TMPG"),[132] or (2) not otherwise be subject to margin requirements with respect to Covered Agency Transactions. Therefore, under the proposed rule changes, the

130 See FINRA Statement at 23-24, 33; Notice, 86 FR at 28163-64.

131 See FINRA Statement at 23-24.

132 See Margining in Agency MBS Trading (Nov. 2012), available at https:// www.newyorkfed.org/medialibrary/microsites/ tmpg/files/margining_tmpg_11142012.pdf ("TMPG Report"). The TMPG Report recommends the best practice of exchanging variation margin for dealer banks. The TMPG is a group of market professionals that participate in the Covered Agency Transaction market and is sponsored by the Federal Reserve Bank of New York.

elimination of the maintenance margin requirement and the remaining requirement to collect the excess net mark to market loss (or take a capital charge, subject to specified terms and conditions) will allow broker-dealers to more effectively compete with banks that either only collect variation margin from their counterparties for Covered Agency Transactions or that do not collect any margin. Consequently, the elimination of the two percent maintenance margin requirement will reduce regulatory requirements for FINRA broker-dealers while promoting consistent margin practices among FINRA members.

While the proposed rule change eliminates the two percent maintenance margin requirement for non-exempt accounts, broker-dealers will continue to be protected from the risks of unsecured credit exposures arising from Covered Agency Transactions because, under the proposed rule change, they must collect the excess net market to market loss from a counterparty or take a capital charge (subject to specified conditions and limitations), unless an exception applies. Further, under current Rule 4210, broker-dealers may collect additional margin (i.e., house margin) from a counterparty above the minimums required by the Covered Agency Transaction margin requirements. Finally, under the current rule, FINRA broker-dealers must perform a written credit risk assessment for each counterparty, which is designed to help them manage the risks of Covered Agency Transactions.

Consequently, this amendment will help to facilitate trading in Covered Agency Transactions by reducing the competitive burdens of the margin requirements for FINRA member broker-dealers, including smaller broker-dealers. This will promote competition by reducing the costs associated with collecting maintenance margin from a counterparty and permitting broker-dealers of all sizes to compete more effectively with banks that are not required to collect maintenance margin or that do not collect any margin from their

counterparties for Covered Agency Transactions. Finally, the continued requirements to collect the excess net mark to market loss from a counterparty and credit risk assessment procedures will continue to protect FINRA-member broker-dealers and investors from the risks of unsecured credit exposures in the Covered Agency Transaction market.

2. Option for Capital Charge in Lieu of Collecting Excess Net Mark to Market Loss

a. Comments Received on Proposal

As discussed in section II.B. above, FINRA proposed, subject to specified conditions and limitations, to provide FINRA broker-dealers the option to take a capital charge in lieu of collecting a counterparty's excess net mark to market loss (i.e., the net mark to market loss to the extent it exceeds $250,000). One commenter indicated that its members were appreciative of the proposed rule change stating that it was consistent with other provisions of FINRA Rule 4210 that permit broker-dealers to take capital charges rather than collect margin for transactions involving securities of high credit quality.[133]

Other commenters opposed the proposed capital charge in lieu of margin stating it would affect liquidity by requiring smaller broker-dealers to take capital charges because they do not have and cannot obtain margin agreements or MSFTAs from their counterparties.[134] For example, the Petitioners, in delineating the types of institutions that participate in the agency

---

133 See Letter from Christopher B. Killian, Managing Director Securitization, Corporate Credit, Libor, SIFMA (June 15, 2021) ("SIFMA Letter") at 5.

134 See Letter from Duncan F. Williams, President, Duncan-Williams Inc., and Brad Jones, Executive Vice President, Managing Director – Correspondent Division, SouthState Bank N.A. (May 10, 2022) ("Duncan-Williams/SouthState Letter") at 2-3; Letter from Michael Decker, Senior Vice President, BDA on behalf of CastleOak Securities; Loop Capital Markets; MFR Securities Inc.; Penserra Securities, R. Seelaus & Co. LLC; Siebert Williams Shank & Co., LLC; and Tigress Financial Parter to Vanessa Countryman, Secretary, Commission (May 10, 2022) ("BDA Small Firms Letter") at 2-3; Letter from DiAnne Calabrisotto, Chief Operating Officer, Siebert Williams Shank & Co., LLC (May 10, 2022) ("Siebert Letter") at 2; Letter from Stephen Berkeley, Chief Compliance Officer and Regulatory Counsel, Loop Capital Markets LLC (May 12, 2022) ("Loop Capital Letter") at 2.

mortgage-backed securities market as investors, stated that pension funds and state agencies may be prohibited by their charters from pledging assets, and as a result would be unable to post margin.[135] Petitioners stated that, partially as a result of counterparties who are unable to post margin, because of the limitation imposed by the 25% TNC / $30MM Threshold, the ability of FINRA members to introduce liquidity into the market during periods of unusual volatility will be drastically limited.[136] Commenters also stated that these smaller broker-dealers would need to maintain a substantial amount of excess net capital in order to comply with the proposed rule, which could reduce liquidity and impair regulatory capital under certain market conditions.[137] These firms, according to commenters, would be unable to commit to purchasing additional mortgage loans until outstanding trades settled, which they stated could prohibit many smaller broker-dealers (including minority, women, and veteran owned firms) from engaging in Covered Agency Transactions or curtail their business.[138] These commenters stated that this, in turn, could reduce market liquidity and disrupt the mortgage origination process which could harm market participants and customers.

Commenters also stated that the proposed rule change would result in potential anti-competitive impacts on small and medium-sized broker-dealers, including women, veteran, and

---

135 See Petition for Review at 8, 33. Petitioners also stated that registered investment companies cannot re-pledge collateral. Id.

136 See Petition for Review at 30, 33.

137 See Duncan-Williams/SouthState Letter at 3-4; BDA Small Firms Letter at 2-3; Letter from Chirag G. Shah, President and Chief Executive Officer, Performance Trust Capital Partners (May 10, 2022) ("Performance Trust Capital Letter") at 2; Letter from Wendy L Brooks, Senior Managing Director, Mesirow Financial, Inc. (May 3, 2022) ("Mesirow Letter") at 2.

138 See Letter from David R. Jones, CastleOak Securities, L.P. (May 10, 2022) ("CastleOak Securities Letter") at 1-2; Weichert Letters at 2; Letter from Kirk R. Malmberg, President and Chief Executive Officer, Federal Home Loan Bank of Atlanta (May 10, 2022) ("Malmberg Letter 2") at 2; Letter from Larry W. Bowden, Executive Vice President, Stephens, Inc. (May 10, 2022) ("Stephens Letter") at 3; BDA Small Firms Letter at 2-3; Williams/SouthState Letter at 3; Siebert Letter at 2; Performance Trust Capital Letter at 2.

minority-owned firms.[139] Specifically, these commenters stated that imposing margin requirements or 100% capital charges on Covered Agency Transactions would cause smaller and mid-sized firms (including women, veteran, and minority-owned firms) to exit the Covered Agency Transaction market or significantly decrease their ability to transact in the market, resulting in greater concentration among fewer market participants, reducing access to the Covered Agency Transaction market or negatively affecting market liquidity.[140] These commenters stated that the proposed amendments would cause them to exit the market or decrease their ability to transact in the market because customers would prefer to transact with banks that are not subject to margin requirements, many customers would be unwilling to enter into margin agreements, the operational and compliance costs of engaging in Covered Agency Transactions would increase significantly, and excessive margin requirements and capital charges would be involved for smaller firms compared to larger firms even though the transactions are riskless to the firm. Other commenters also stated that the proposed requirements, either in whole or in part, are not suitable for Specified Pool Transactions and CMOs.[141] One commenter also expressed concern that an early survey of its customers indicated that many of its customers are uncomfortable with executing an MSFTA that indicates that there is a potential liquidity event or margin call in a volatile market, even if unlikely, and that bank

---

139 See SIFMA Letter at 2-3; Letter from Michael Decker, Senior Vice President, Public Policy, Bond Dealers of America (June 15, 2021) ("BDA Letter") at 4-5; Letter from Thomas J. Fleming & Adrienne M. Ward, Olshan, on behalf of Brean Capital, LLC (June 15, 2021) ("Brean Capital Letter") at 18-21; Letter from Kirk R. Malmberg, President and Chief Executive Officer, Federal Home Loan Bank of Atlanta (Jan. 18, 2022) at 1-2 ("Malmberg Letter 1"); Letter from Senator John Boozman, Senator Thom Tillis, and Senator Cynthia M. Lummis (Jan. 10, 2022) ("Boozman et al Letter") at 1-2; Petition for Review at 26-29; Duncan-Williams/SouthState Letter at 2-3; Stephens Letter at 2; Mesirow Letter at 2; Loop Capital Letter at 2.

140 See SIFMA Letter at 2-3; BDA Letter at 4-5; Brean Capital Letter at 18-20; Malmberg Letter 1 at 1-2; Boozman et al Letter at 1-2; Petition for Review at 27-31; Stephens Letter at 2; BDA Small Firms Letter at 3.

141 See Letter from Chris Melton, Individual (Aug. 2, 2021) ("Melton Letter") at 1; SIFMA Letter at 1-3.

affiliated firms do not require the execution of such a document.[142] One commenter suggested that the proposed capital charges in lieu of margin should be applied at 10% rather than at 100% of the excess net mark to market loss.[143] Commenters also expressed concerns that the proposed rule change would have a disparate impact on underserved communities which smaller firms typically serve and stated that FINRA did not specifically consider the consequences and impact the proposal would have on the housing finance sector and access to the liquidity for underserved communities.[144] Consequently, commenters believe that the proposed rule change will cause smaller broker-dealers to exit the market, resulting in decreased competition and liquidity in the Covered Agency Transaction market.[145]

Further, the Petitioners stated that the proposed rule change would increase systemic risk, as the option to take a capital charge in lieu of margin with its associated 25% TNC / $30MM Threshold, would force regional broker-dealers to suspend trading in Covered Agency Transactions after a few trades or to liquidate customer positions, and cause customers to move their business to banks which could transform moderate market volatility into a liquidity crisis.[146]

---

142 See Stephens Letter at 2.

143 See Brean Capital Letter at 25.

144 See Petition for Review at 41-42; Letter from Alanna McCargo, President, Government National Mortgage Association (Jan. 20, 2022) at 1-2.

145 See Petition for Review at 30-31.

146 Petitioners also stated that the proposed rule change would enhance systemic risk as a result of several factors. These factors include: (1) removing liquidity from agency mortgage-backed security markets; (2) introducing uncertainty into the market due to the difference between trade prices and mark to market losses for calculation of margin; (3) failing to provide a solution to the "chain" fail problem; (4) increasing the bargaining power of primary dealers to the detriment of introducing brokers; and (5) encouraging a shift in business to banks by broker-dealers with bank affiliates. See Petition for Review at 31-33, 37-38. Petitioners also stated that the 25% TNC / $30MM Threshold will limit large broker-dealers from introducing liquidity in the market in times of stress which may add volatility to the market. See Petition for Review at 30. See section III.B. below for a discussion of the concerns commenters raised regarding chain of fails and the calculation of variation margin.

Petitioners also stated that the Division staff, in approving the 2021 Amendments by delegated authority, failed to engage in reasoned decision-making, and that FINRA never identified the market participants it engaged with or the substance of the conversations with them. Petitioners further stated that FINRA did not offer any evidence or data to support the need for the proposed changes or the need for FINRA to establish a margin regime for Covered Agency Transactions.[147] Petitioners also stated that the proposed rule change is unnecessary and an abuse of discretion and that the rule is unworkable, increases systemic risk, and will have a catastrophic effect on regional broker-dealers. They stated that despite FINRA's efforts to mitigate the harms to smaller market participants and lessen the burdens that it will impose on competition, these burdens remain significant, unnecessary and inappropriate.[148]

Finally, one commenter stated that the March 2020 period of volatility during the COVID-19 pandemic provided a perfect example of a situation when margin flexibility on the part of broker-dealers was necessary[149] and that if this situation were replicated in the future, the amendments would effectively remove the ability of broker-dealers to exercise appropriate discretion with respect to their clients' positions and would contribute to market stress.[150]

b. FINRA's Response to Comments

In response to the comments to the Notice, FINRA stated that it has engaged with industry participants extensively on their concerns, and has addressed them on multiple occasions since the process of soliciting comment on requirements for Covered Agency

147 See Petition for Review at 43-45.

148 See Letter from Thomas J. Fleming, Adrienne M. Ward, Olshan, David H. Thompson, Cooper & Kirk, PLLC Harold Reeves, Esq., Cooper & Kirk, PLL on behalf of BDA and Brean Capital (Sept. 10, 2021) ("BDA and Brean Capital Letter") at 32-42; Petition for Review at 26-27.

149 See MBA Letter at 2.

150 See MBA Letter at 2.

Transactions began in January 2014 with the publication of Regulatory Notice 14-02 and in 2015 with FINRA's original rulemaking for Covered Agency Transactions.[151] FINRA also stated that the original rulemaking is necessary because of the risks posed by unsecured credit exposures in the Covered Agency Transactions market.[152]

FINRA also stated that it has addressed, on multiple occasions, the need to include Specified Pool Transactions and CMOs within the scope of the requirements,[153] and made key revisions in finalizing the 2016 Amendments expressly to mitigate any potential impact on smaller firms and on activity in the Covered Agency Transaction market, including increasing the small cash counterparty exception from $2.5 million to $10 million, subject to specified conditions, and modifying the two percent maintenance margin requirement, as adopted pursuant to the original rulemaking, to create an exception for cash investors that otherwise would have been subject to the requirement.[154]

FINRA also exempted mortgage bankers from the maintenance margin requirements in the 2016 Amendments; exempted multifamily housing securities and project loan program securities from the new margin requirements;[155] and established a $250,000 de minimis transfer

---

151 See Amendment No. 1 (2021) at 4; Exchange Act Release No. 76148 (Oct. 14, 2015), 80 FR 63603 (Oct. 20, 2015) (Notice of Filing of a Proposed Rule Change to Amend FINRA Rule 4210 (Margin Requirements) to Establish Margin Requirements for the TBA Market; File No. SR-FINRA-2015-036) ("2015 Notice"); Regulatory Notice 14-02 (Jan. 2014). Even before the publication of these materials, as discussed in SR-FINRA-2015-036, FINRA highlighted that it had engaged in extensive outreach and consultation with market participants and staff of the Federal Reserve Bank of New York and the Commission staff. See 2015 Notice, 80 FR at 63604-05. In Partial Amendment No. 3 to SR-FINRA-2015-036, FINRA stated that up to that time there had been four opportunities for public comment on the original rulemaking, beginning with Regulatory Notice 14-02, available at https://www.finra.org/rules-guidance/rule-filings/sr-finra-2015-036.

152 See Amendment No. 1 (2021) at 4-5 and 2015 Notice, 80 FR at 63615-16.

153 See Amendment No. 1 (2021) at 5 and 2016 Approval Order, 81 FR at 40371.

154 See Amendment No. 1 (2021) at 5.

155 See Amendment No. 1 (2021) at 5-6 and Partial Amendment No. 1 to SR-FINRA-2015-036, available at https://www.finra.org/rules-guidance/rule-filings/sr-finra-2015-036.

amount, for a single counterparty, subject to specified conditions, up to which members need not collect margin or take a charge to their net capital.[156]

Additionally, FINRA stated that once the Commission approved the 2016 Amendments that it would monitor the impact of the new requirements and, if the requirements proved overly onerous or otherwise were shown to negatively impact the market, it would consider amending such requirements to mitigate the rule's impact.[157] Industry participants requested that FINRA monitor the potential impact of the 2016 Amendments on smaller and mid-sized firms, and that FINRA extend the implementation date of the requirements pending its consideration of any potential amendments to the rule.[158] In response to the concerns of industry participants, FINRA also stated that it engaged in extensive dialogue, both with industry participants and other regulators, including staff of the Commission and the Federal Reserve System, for purposes of amending the 2016 Amendments.[159] Further, FINRA extended the implementation date of the margin collection requirements pursuant to the 2016 Amendments on multiple occasions.[160]

FINRA stated that it developed the proposed rule change in direct response to the concerns of industry participants, and in citing the risks posed by unsecured credit exposures that exist in the Covered Agency Transaction market, stated that it has proposed two key revisions designed to afford relief to industry participants:[161] (1) eliminating the two percent maintenance margin requirement with respect to non-exempt accounts for purposes of their Covered Agency

156 See Amendment No. 1 (2021) at 6 and 2016 Approval Order, 81 FR at 40368.

157 See Amendment No. 1 (2021) at 6 and Partial Amendment No. 3 to SR-FINRA-2015-036.

158 See Amendment No. 1 (2021) at 6.

159 See Amendment No. 1 (2021) at 6.

160 See Amendment No. 1 (2021) at 6 and Notice, 86 FR at 28162.

161 See Amendment No. 1 (2021) at 6 and Notice, 86 FR at 28162-63.

Transactions;[162] and (2) subject to specified conditions and limits, permitting members to take a capital charge in lieu of collecting margin for each counterparty's excess net mark to market loss.[163] FINRA believes the amendments to the original rulemaking as set forth in the proposed rule change, with the additional clarifications it has provided to commenters, afford industry participants appropriate relief and clarity, and that the proposed rule change should be approved.[164]

Further, in response to the additional comments received regarding the 2021 Order Instituting Proceedings, FINRA stated that commenters have repeatedly expressed the same points, including during the original rulemaking, which FINRA stated it has repeatedly addressed, and that it believes the rulemaking is necessary because of the risk posed by unsecured credit exposures in the Covered Agency Transaction market.[165] FINRA also stated that recent events in connection with market volatility stemming from the COVID-19 pandemic[166] have illustrated the importance of risk and exposure limits,[167] and that these events reinforce that FINRA's attention to unsecured exposures in the Covered Agency Transaction market, in view of its significance to the U.S. mortgage market and financial system generally, is rationally founded. FINRA stated that the Covered Agency Transaction market today is

---

162 This proposal is discussed in section III.A.1. above.

163 See Amendment No. 1 (2021) at 6-7. This proposal is discussed in section III.A.2. above.

164 See Amendment No. 1 (2021) at 7.

165 See FINRA Letter at 4-7. For example, FINRA stated that BDA and Brean Capital contended that permitting members to take the capital charge in lieu of colleting margin is untenable, that having requirements for Covered Agency Transactions would have the effect of causing a "chain" of fails, that firms will be driven from the market and that FINRA has not addressed critical questions as to how the requirements will work. In response, FINRA stated that these arguments are not novel and that FINRA exhaustively addressed them with industry participants throughout the course of the 2016 Amendments and the development of the proposal. FINRA also stated that it provided extensive further explanations in Amendment No. 1 (2021). See id. at 7.

166 See FINRA Letter at 5, n.17 (citing DERA Report).

167 See FINRA Letter at 5.

substantial and that the regulatory need for attention to this area is no less than when FINRA initiated the original rulemaking.[168]

In response to the Petition for Review and comments that FINRA failed to engage in reasoned decision-making or provide evidence or data to support the proposal, FINRA stated that record supports the narrow amendments under the proposed rule change. FINRA further stated that rather than imposing new requirements, the narrow amendments to FINRA Rule 4210 in the proposal address—and in fact reduce the potential burden of—amendments to FINRA Rule 4210 included in the 2016 Amendments.[169] Specifically, in its Statement, FINRA stated that permitting FINRA members to take a capital charge in lieu of collecting mark to market margin was a change that was specifically motivated by its efforts to address concerns that the 2016 Amendments could create an unfair disparity between large brokers and small and medium-sized brokers, and that various small broker-dealers commented during the rulemaking process that being permitted to take a capital charge in lieu of margin would help alleviate the competitive disadvantage that small and medium-sized firms face in obtaining margin agreements with counterparties, as it would provide an alternative to collecting margin.[170] FINRA further stated that in a 2018 letter, BDA, one of the Petitioners, requested that FINRA adopt a provision that would permit members to take a capital charge in lieu of margin as BDA indicated that discussions with two small broker-dealers indicated that this would allow those small broker-dealers the ability to remain competitive and would not erode their capital.[171]

---

168 See FINRA Letter at 6. As of the second quarter of 2021, total average daily dollar trading volume for these types of products as reflected in FINRA Trade Reporting and Compliance Engine ("TRACE") data was approximately $300 billion. Id. at 5-6.

169 See FINRA Statement at 9, and 21-22.

170 See FINRA Statement at 24-25.

171 See FINRA Statement at 25 (citing BDA 2018 Letter). FINRA stated that BDA in reciting its own

FINRA further stated that the whole purpose of the 2021 Amendments is to respond to the types of concerns raised by smaller firms by providing greater flexibility than they have under the current rule.[172] Further, FINRA stated that the proposed rule permits FINRA members a limited capacity to take capital charges in lieu of collecting margin and thereby assume the risk of counterparty default, and that could help FINRA members to establish (or maintain) relationships with counterparties who are not willing to post margin.[173]

FINRA has stated that it intends to monitor the proposed rule's implementation and its impact.[174] FINRA stated it remains committed to ensuring that FINRA Rule 4210, as amended, in practice, does not disadvantage smaller broker-dealers who are most focused on community institutions, including those owned by women, minorities and veterans.[175] FINRA also stated that the proposed rule demonstrates FINRA's commitment to smaller firms in action, as FINRA is pro-actively responding to concerns raised by market participants and proposing appropriate amendments to FINRA Rule 4210.[176]

In addition, with respect to comments that FINRA failed to engage in reasoned decision making regarding the 2021 Amendments, FINRA stated it complied with all applicable procedural requirements.[177] FINRA stated that the Petitioners used the record in the 2021

---

discussions with two smaller broker-dealers who expressed support for a capital charge in lieu of margin option, wrote that the two smaller broker-dealers believed "the Capital Charge Proposal would give them many options to remain competitive in [Covered Agency Transactions]" and that they were "not concerned that the Capital Charge Proposal [would] be anticompetitive" or force them to "erode away their capital in order to be competitive." BDA 2018 Letter at 2 (cited in FINRA Statement at 25).

172 See FINRA Statement at 33.

173 See FINRA Statement at 33.

174 See FINRA Statement at 34.

175 See FINRA Statement at 34.

176 See FINRA Statement at 34.

177 See FINRA Statement at 29.

Amendments to take issue with FINRA's adoption of margin requirements for Covered Agency Transactions in the 2016 Amendments.[178] FINRA stated that it was not required to re-do the entire rulemaking process that led to the approval of the 2016 Amendments to make amendments to the current rule, and that the Commission is not required to re-canvass a rulemaking process that stretches back to 2014 to approve the 2021 Amendments to an already-approved rule change.[179] FINRA also stated in response to Petitioner's comments that it did not disclose who it consulted with in the development of the 2021 Amendments as mischaracterizing the record.[180] FINRA stated it set forth the process it undertook to develop the 2021 Amendments in the proposal, and that the record contains a lengthy and detailed analysis of comments received.[181] Finally, FINRA stated that the rationale for SR-FINRA-2021-010 is clearly supported in the administrative record by detailed and rigorous assessments of any burden imposed on competition (including thorough analysis of economic impact assessments, anticipated benefits, anticipated costs, and alternative approaches).[182]

FINRA stated that the proposed rule change promotes competition by leveling the playing field among Covered Agency Transaction market participants of all sizes, thereby reducing disruption in this market without the loss of any investor protection.[183] Further, FINRA stated by limiting the ability of larger members to take a capital charge, the proposal promotes competition in the market, particularly for smaller broker-dealers.[184] FINRA believes that the

178 See FINRA Statement at 29.

179 See FINRA Statement at 29-30.

180 See FINRA Statement at 30.

181 See FINRA Statement at 30.

182 See FINRA Statement at 23.

183 See FINRA Statement at 26.

184 See FINRA Statement at 35.

amendments set forth in the proposed rule change strike an appropriate balance in providing small and medium-sized FINRA member broker-dealers with an alternative to collecting margin, while ensuring that the regulatory objective of FINRA Rule 4210, as amended by the proposed rule, is not undermined by limiting the option to take a capital charge with the 25% TNC / $30MM Threshold.[185]

FINRA stated that it disagrees with commenters' concerns that the 25% TNC / $30MM Threshold is a flaw in the proposal, as the objective of the proposed rule change is to encourage the collection of margin.[186] FINRA stated that the purpose of FINRA Rule 4210, as amended by the 2016 Amendments and 2021 Amendments, is to shore up the practices in the Covered Agency Transaction market by encouraging the margining of those positions—not to allow members to avoid such requirements through the taking of a large net capital charge. FINRA stated that allowing firms to take a capital charge in lieu of margin is meant to add flexibility to the rule, not to supplant its margin requirements.[187] FINRA stated that in effect, the 25% TNC / $30MM Threshold is a risk management mechanism given the introduction of the proposed capital charge option.[188] FINRA stated that for some FINRA members, the volume of business may reach the threshold where further capital charges cannot be taken, and at that point, the 25% TNC / $30MM Threshold would then prevent the member from entering into new Covered Agency Transactions with any counterparty that cannot or will not post margin.[189] While the ability of the FINRA member to inject liquidity into the Covered Agency Transaction market

185 See FINRA Statement at 26.

186 See FINRA Statement at 26.

187 See FINRA Statement at 26.

188 See FINRA Statement at 35.

189 See FINRA Statement at 35.

could potentially be reduced, FINRA stated that raising the threshold for permitted capital charges would reduce the effectiveness of the 2021 Amendments by increasing the FINRA member's exposure to the risk of counterparty default and would undermine the goal of promoting and supporting competition in the market by allowing larger FINRA members that are more able to commit capital to avoid collecting margin.[190] In addition, FINRA stated that permitting a capital charge to substitute completely for the collection of margin would undermine the core regulatory objectives of the margin requirements for Covered Agency Transactions to reduce the risk of unsecured exposures to Covered Agency Transactions and to encourage the collection of margin.[191]

FINRA also stated that permitting capital to substitute wholly for the requirement to collect margin would exacerbate, rather than address, the disparity between small and medium-sized firms and larger competitors, as larger competitors would be able to use their larger balance sheets to effectively avoid the margin requirements altogether, to the disadvantage small and medium-sized firms.[192] Because taking a capital charge is optional, FINRA stated that members will only commit capital in lieu of margin when they believe it appropriately balances the benefits and risks.[193] FINRA stated it intended to keep strong incentives to collect margin and use the amendments only to allow flexibility in complying with the rule.[194]

In response to Petitioners' comments that certain entities, such as pension funds and state agencies, may be unable to post margin, or that registered investment companies are not

---

190 See FINRA Statement at 35.

191 See FINRA Statement at 26-27.

192 See FINRA Statement at 26-27.

193 See FINRA Statement at 27.

194 See FINRA Statement at 27.

permitted to re-pledge collateral, FINRA stated that it disagrees, arguing that Petitioners do not explain why registered investment companies could not re-pledge collateral subject to appropriate custody arrangements.[195] In addition, to the extent Petitioners assert that registered investment companies or pension plans cannot post margin, FINRA believes they are incorrect, stating that it believes that registered investment companies can post margin.[196] FINRA stated that these entities are simply required to account for the obligation to post margin as part of their potential exposures with respect to derivative transactions, as a condition to their derivative obligations not being subject to more general restrictions on such companies' ability to incur debt.[197] In addition, FINRA stated that it believed that, under a 2013 Advisory Opinion from the Department of Labor, ERISA pension plans can post both initial and variation margin, and the assets deposited with the counterparty "to support payment obligations that may become necessary for the plan" "would not be plan assets for the purposes of Title I of ERISA."[198] Finally, FINRA stated that, in any event, the proposed amendment that would permit FINRA members to substitute a capital charge for the collection of margin is intended to provide the very flexibility Petitioners seek to continue to deal with counterparties who are unable or unwilling to post margin, while maintaining the overall effectiveness of the rule.[199]

---

195 See FINRA Statement at 27-28.

196 See FINRA Statement at 28.

197 See FINRA Statement at 28. Specifically, FINRA cites to a Commission release regarding the use of derivatives by registered investment companies and business development companies to argue that registered investment companies can post margin, but must account for the obligation to post margin as part of their potential exposures to derivatives transactions as a condition to their derivative obligations not being subject to more general restrictions on the ability to incur debt. See Use of Derivatives by Registered Investment Companies and Business Development Companies, Investment Company Act Release No. 34084 (Nov. 20, 2020), 85 FR 83162, 83175 (Dec. 21, 2020) (File No. S7-24-15).

198 See FINRA Statement at 28; Department of Labor Advisory Opinion 2013-01A (Feb. 7, 2013).

199 See FINRA Statement at 28.

In response to the comment that the proposed amendment will increase systemic risk or that FINRA failed to consider it, FINRA stated that systemic risk was one of the original reasons FINRA proposed the 2016 Amendments in the first place.[200] Further, FINRA stated that the 2021 Amendments are part of an effort by FINRA to address a significant source of potential systemic risk, and risk to its members: the risk of exposure to counterparty defaults on the purchase of forward-settling Covered Agency Transactions during the often lengthy period between trade and settlement dates.[201] In addition, FINRA stated that to the extent that certain market participants are no longer able to take on the same amount of risk that they were prior to the 2016 Amendments that will reduce systematic risk rather than increase it.[202]

In response to comments that the proposed rule change may result in higher capital or margin charges, FINRA stated that, in some of these scenarios, commenters attributed the higher margin or capital requirements to the fact that the transactions (termed "non-netting" by one commenter and "non-nettable" by another) will not net under the proposed rule change.[203] According to FINRA, the only requirement to be able to net transactions in determining a counterparty's "net mark to market loss" is that the member have a legal right to offset losses on one transaction against gains on the other (or a security interest that would allow it to apply gains on one transaction to the counterparty's losses on the other).[204]

---

200 See FINRA Statement at 42.

201 See FINRA Statement at 2, 5, 8.

202 See FINRA Statement at 42. FINRA stated that unmargined positions in the TBA market could raise systemic concerns, because, if one or more counterparties defaulted, the interconnectedness and concentration in the TBA market may lead to potentially broadening losses and the possibility of substantial disruption to financial markets and participants. Id.

203 See Amendment No. 1 (2021) at 7-8.

204 See Amendment No. 1 (2021) at 7-8.

FINRA acknowledged that the margin requirements and capital charges under both the proposed rule change and the current rule are higher in certain scenarios (and lower in others) than they would be under a commenter's suggestion that (1) there should be no margin requirements applicable to Covered Agency Transactions (up to the second monthly SIFMA settlement date),[205] and (2) members should be required to take capital charges for only ten percent of their counterparties' unmargined mark to market losses.[206] FINRA stated that it believes that these suggestions would significantly undercut the objective of the rule to protect against the risk of unsecured credit exposure in Covered Agency Transactions.[207] In addition, FINRA stated that the same factors that make smaller firms more sensitive to the margin requirements also make them more vulnerable to the risk of counterparty default, which such firms may be less able to absorb, underscoring the need for the margin requirement regime. Further, FINRA stated that the current rule, would, subject to specified exceptions, require members to collect margin whenever their counterparties' mark to market losses (and two percent maintenance margin deficiency, where applicable) exceeds $250,000, and would require them to take a capital charge to the extent such margin is not collected by the close of business on the business day after such mark to market loss (or maintenance margin deficiency) arose.[208] FINRA stated that the proposed rule change preserves all of the exceptions in the current rule,

---

205 See section III.F.3. below for FINRA's responses to comments and the Commission's findings related to moving the margin collection date to a longer period.

206 According to FINRA, under the current rule and the proposed rule change, members are not required to collect margin, or take capital charges in lieu of collecting margin, to cover the net mark to market losses of small cash counterparties, registered clearing agencies, Federal banking agencies (as defined in 12 U.S.C. 1813(z)), central banks, multinational central banks, foreign sovereigns, multilateral development banks, or the Bank for International Settlements. FINRA stated that these exceptions mean that some members engaging in Covered Agency Transactions with these counterparties may have lower margin and capital requirements under the current rule and the proposed rule change than they would under the commenter's suggestion. See Amendment No. 1 (2021) at 9; FINRA Statement at 34.

207 See Amendment No. 1 (2021) at 8-9; FINRA Statement at 34.

208 See Amendment No. 1 (2021) at 8.

eliminates the two percent maintenance margin requirement, and provides an option, subject to specified terms and conditions, to take capital charges in lieu of collecting margin for net mark to market losses in excess of $250,000.[209] Because the proposed rule change eliminates the two percent maintenance margin requirement and related capital charges for uncollected maintenance margin, FINRA stated that the margin requirements and capital charges under the proposed rule change are less than the requirements under the current rule.[210]

c. Commission Discussion and Findings

In proposing to permit broker-dealers the option to take a capital charge in lieu of collecting the excess net mark to market loss from a counterparty, FINRA has reasonably balanced the goal of reducing the potential competitive impacts of the current rule on small and medium-sized broker-dealers, while maintaining the objectives of the original rulemaking to reduce a broker-dealer's risk arising from unsecured credit exposures to Covered Agency Transactions, and to encourage the collection of margin. As an initial matter, this aspect of the proposal does not add any new requirements (including any new margin collection requirements); rather, it provides an additional option to broker-dealers to comply with the rule's requirements. This option, therefore, should facilitate securities transactions in the Covered Agency Transaction market by providing additional flexibilities to broker-dealers while continuing to protect investors and the public from potential losses arising from risks of unsecured exposures in the Covered Agency Transaction market.[211]

---

209 See Amendment No. 1 (2021) at 8.

210 See Amendment No. 1 (2021) at 8. The proposal to eliminate the two percent maintenance margin requirement is discussed in section III.A.1. above.

211 For example, the option to take a capital charge also will give broker-dealers the flexibility to engage in Covered Agency Transactions with counterparties that may be prevented by contract or otherwise from posting margin to a broker-dealer.

Further, the current rule includes a number of exceptions designed to alleviate the impact of the Covered Agency Transaction margin requirements on smaller firms and counterparties, including the small cash counterparty exception, an exception from collecting margin or taking a capital charge on the first $250,000 net mark to market loss from any counterparty, and the exclusion of multifamily housing securities and project loan program securities from the scope of the current rule.[212] The proposal retains these exceptions in the current rule, and builds on them to provide even more flexibility to broker-dealers, including small and medium-sized broker-dealers, through the narrow amendment to permit them the option to take a capital charge in lieu of collecting the excess net mark to market loss from a counterparty in a Covered Agency Transaction.[213]

The option to take a capital charge in lieu of collecting excess net mark to market margin will promote competition for smaller broker-dealers in relation to regional banks not subject to margin requirements, and larger broker-dealers which may have more market power to obtain margin agreements and collect margin from their counterparties. The proposed rule reduces regulatory burden for broker-dealers, including smaller broker-dealers, from the requirements under the current rule to collect margin from a counterparty where there is no exception, by providing broker-dealers the option to take a capital charge in lieu of collecting the excess net

---

212 See 2016 Approval Order, 81 FR at 40375.

213 For example, if a small broker-dealer has a counterparty that has $9 million in exposure to Covered Agency Transactions in their account, the counterparty would be excluded from the scope of the rule because they are a "small cash counterparty," and the broker-dealer would not need to collect margin or take a capital charge with respect to this account. If the same counterparty's exposure to Covered Agency Transactions increased to $11 million, the broker-dealer would be required to collect margin or take a capital charge only when the net mark to market loss exceeded $250,000. The broker-dealer is not required to take a capital charge or collect the net market to market loss unless it exceeds $250,000 (i.e., the excess net mark to market loss). When the amount of the net mark to market loss exceeds $250,000, the broker-dealer must collect the amount that exceeds $250,000 or take a capital charge, subject to the 25% TNC / $30MM Threshold. The small cash counterparty exception and the $250,000 mark to market loss exception also do not count toward the calculation of the 25% TNC / $30MM Threshold.

mark to market loss. This option will permit broker-dealers to attract or retain counterparties from whom they do not collect margin thereby allowing them to more effectively compete with regional banks and large broker-dealers, and to transact with counterparties that may not be able to—or who are unwilling to—post margin.[214] The option to take a capital charge in lieu of collecting the excess net mark to market loss from a counterparty directly responds to comments that counterparties will elect to transact with regional banks that are not subject to margin requirements and the proposal will cause smaller broker-dealers to exit the Covered Agency Transaction market or reduce their Covered Agency Transaction business.

The option to take a capital charge in lieu of collecting the excess net mark to market loss from a counterparty will require a broker-dealer to set aside net capital to address the risks of unsecured credit exposures in the Covered Agency Transaction market that are mitigated through the collection of margin collateral. The net capital set aside will serve as an alternative to obtaining margin collateral for the purpose of reducing the risk of unsecured credit exposures to the broker-dealer, as well as potential losses in the event of a counterparty default. The proposed rule, therefore, should reduce the risk of loss to the broker-dealer, and enhance, rather than, deplete the liquidity of a broker-dealer. The requirement to collect margin or take a capital charge in lieu of collecting the excess mark to market loss from a counterparty also is consistent

---

214 Petitioners suggested that certain counterparties cannot post margin. The proposed capital in lieu of margin charge is intended to provide broker-dealers flexibility in cases where the broker-dealer does not collect margin from a counterparty to a Covered Agency Transaction. Petitioners also stated that registered investment companies cannot re-pledge collateral without explaining why or how this would impact the ability of such entities to post margin. While posting margin may not be explicitly prohibited, the Commission notes that any entity that posts margin must do so in compliance with applicable law. For example, registered investment companies are subject to the provisions set forth in Sections 17(f) and 18 of the Investment Company Act of 1940 regarding custody and the issuance of senior securities, respectively, as well as the rules promulgated thereunder (e.g., Rule 18f-4, which addresses the use of derivatives by registered investment companies, among others).

with other regulatory efforts that have sought to address the risk of uncollateralized exposures arising from different types of bilateral transactions with counterparties.[215]

Further, the Commission agrees with FINRA that the regulatory need for attention to this area is no less than when FINRA initiated the original rulemaking. For example, during March 2020, the prices of agency mortgage-backed securities declined and transaction costs (bid-ask spreads) rose, leading to tightened liquidity in the agency mortgage-backed security repurchase agreement (or "repo') market.[216] These events highlight the need to reduce the risk of uncollateralized exposures in the Covered Agency Transaction market. Unsecured exposures in the Covered Agency Transaction market could raise systemic concerns, in that if one or more counterparty to a Covered Agency Transaction defaults, the interconnectedness and concentration in the Covered Agency Transaction market may lead to potentially broadening losses and the possibility of substantial disruption to financial markets and participants. Further, to the extent that certain market participants cannot increase their leverage through unsecured exposures because they must collect the excess net market to market loss from their counterparties in a Covered Agency Transaction, or take a capital charge, that will serve to reduce systemic risk rather than increase it. Consequently, while the proposed rule does not entirely alleviate the competitive burdens on smaller broker-dealers, the option to take a capital charge in lieu of collecting the excess net mark to market loss reduces competitive burdens in a measured way that retains the protections of the current rule to reduce the risk of unsecured

---

215 See, e.g., Exchange Act Rule 18a-3 (imposing margin requirements on non-cleared security-based swap transactions for security-based swap dealers and major security-based swap participants); FINRA Rule 4240 (prescribing margin requirements for non-cleared security-based swaps for FINRA member broker-dealers that are not registered as security-based swap dealers).

216 See DERA Report at 69; See also Letter from Robert D. Broeksmit, CMB President and Chief Executive Officer, MBA to Robert W. Cook, Chief Executive Officer, FINRA and Jay Clayton, Chairman, Commission (Mar. 29, 2020) (attached as Appendix B to MBA Letter) ("MBA 2020 Letter") (asking for flexibility in margin practices at broker-dealers during March 2020).

credit exposures in the Covered Agency Transaction market without diminishing investor protection.[217]

The continued requirement to collect margin for the excess net mark to market losses or take a capital charge in lieu of collecting margin for the excess net mark to market losses also will remove the possibility that FINRA members will compete through the implementation of lower margin levels (or no margin requirements) for Covered Agency Transactions. As such, the proposed rule change will require consistent practices among FINRA member broker-dealers in terms of collecting margin for a Covered Agency Transaction or holding sufficient capital to serve as a risk-reducing alternative to collecting margin.

With respect to the comments from small broker-dealers that raised concerns that they will need to rely almost exclusively on the capital in lieu of margin charges,[218] as stated above, the proposal does not add any new requirements; rather, it provides an additional option to broker-dealers to comply with the rule's requirements through a capital charge. In addition, since the adoption of the current rule, broker-dealers already have been adjusting to the Covered Agency Transaction margin requirements by negotiating and entering into margin agreements with their customers, which should permit them to collect margin when necessary, and reduce the likelihood of reaching the 25% TNC / $30MM Threshold.[219] Further, the proposed rule change provides that a broker-dealer with non-margin counterparties must establish and enforce risk management procedures reasonably designed to ensure that the optional capital charges do

---

217 The record also demonstrates that FINRA conducted an Economic Impact Assessment of the proposed rule change, including the anticipated competitive effects, the anticipated costs and benefits and alternatives considered. See Notice, 86 FR 28166-68.

218 Smaller broker-dealers stated they must rely on the optional capital charge because they cannot or are not able to enter into margin agreements with customers.

219 See Notice, 86 FR at 28167; MBA 2020 Letter; MBA Letter.

not exceed $25 million, and promptly notify FINRA if the amount of specified net capital charges exceeds $25 million for five consecutive business days. These additional risk management procedures for broker-dealers with non-margin counterparties under the proposed rule change should reduce the likelihood that a smaller broker-dealer will exceed the 25% TNC / $30MM TNC Threshold.

For some broker-dealers, their volume of business may reach the 25% TNC / $30MM Threshold where the broker-dealer cannot take further capital charges, and at that point, the 25% TNC / $30MM Threshold would then prevent the broker-dealer from entering into any new Covered Agency Transaction with a counterparty that is unable or unwilling to post margin. While the ability of a broker-dealer to inject liquidity into the Covered Agency Transaction market could potentially be reduced until it falls below the 25% TNC / $30MM Threshold, raising the threshold for permitted optional capital charges would undermine the effectiveness of the proposed rule change by increasing the broker-dealer's uncollateralized exposures to Covered Agency Transactions, and thereby increase the risk of a counterparty's default. In summary, the option to take a capital charge in lieu of collecting margin, along with the exceptions in the current rule and the additional risk management procedures for non-margin counterparties should provide broker-dealers (including smaller broker-dealers) sufficient flexibilities to enable them to better compete in the Covered Agency Transaction market (including participating in the housing finance sector and providing access to liquidity for underserved communities), while encouraging them to collect margin from their counterparties.[220]

---

[220] See Notice 86 FR at 28164. In addition to broker-dealers, other market participants such as banks of all sizes may provide liquidity to the Covered Agency Transaction market.

The Commission agrees with FINRA that allowing firms to take a 100 percent capital charge in lieu of collecting excess net mark to market loss without the limitation of the 25% TNC / $30MM Threshold will exacerbate the competitive disparity between large and small broker-dealers. Because large broker-dealers will have a larger capital base than small broker-dealers, the absence of a threshold would enable large broker-dealers to take more capital charges if they did not wish to collect margin from customers. Consequently, customers of small broker-dealers could opt to enter into transactions with larger broker-dealers instead of transacting with smaller broker-dealers in order to avoid posting margin, allowing larger broker-dealers to use their larger capital base to competitively disadvantage smaller broker-dealers.

In addition, in response to a concern expressed in the Petition for Review,[221] the Commission does not believe that the 25% TNC / $30MM Threshold will limit a large broker-dealer's ability to provide liquidity to the market in times of stress. As discussed above, larger broker-dealers have more market power to negotiate margin agreements with their counterparties and to collect margin (in contrast to smaller broker-dealers). Consequently, large broker-dealers generally should have the ability to collect the excess net mark to market loss from a counterparty rather than relying on the optional capital charges. Therefore, the 25% TNC / $30MM Threshold should not limit their ability to engage in Covered Agency Transactions in times of volatility and to provide liquidity to the market.[222]

The Commission disagrees with commenters' statements that despite FINRA's efforts to mitigate the harms to smaller market participants and lessen the burdens the proposed rule change will impose on competition, these burdens remain significant, unnecessary and

---

221 See Petition for Review at 30.

222 See Notice, 86 FR at 28162.

inappropriate. As described above, the only amendments to the current rule before the Commission under the proposed rule change, as modified by Amendment No. 1 (2021), are to eliminate the two percent maintenance margin requirement, permit capital in lieu of margin charges, and to reorganize and streamline the rule text. These proposed amendments build upon the already existing exceptions adopted in the 2016 Amendments, which, as discussed above in this section III.A.2.c., are retained in the proposed rule. While the Commission appreciates the recommendations made by various commenters, and recognizes that the Amended Margin Collection Requirements may result in increased costs for some FINRA members and their counterparties, the Commission believes that FINRA responded appropriately to their concerns. Taking into consideration the comment letters, FINRA's responses to the comments, the Petition for Review, and the statements received in response to the Petition for Review, the Commission believes that the proposed rule change, as modified by Amendment No. 1 (2021), is consistent with the Exchange Act. In structuring the proposed rule change, as modified by Amendment No. 1 (2021), to allow for additional flexibilities with the option to take a capital charge in lieu of collecting the excess net mark to market loss, FINRA has reasonably balanced the goal of reducing unsecured credit exposures in the Covered Agency Transaction market and encouraging the collection of margin, with the potential costs and competitive impacts that may result from the proposed rule change.[223] FINRA has stated it remains committed to ensuring that FINRA Rule 4210, as amended, in practice, does not disadvantage smaller broker-dealers who are most focused on community institutions, including those owned by women, minorities and veterans.[224] Finally, the Commission believes that commenters other suggestions to exclude additional

---

223 See section I.B. above (detailing the procedural history and background of Covered Agency Transaction margin requirements for the 2016 and 2021 Amendments).

224 See FINRA Statement at 34.

product types or counterparties from the rule, reduce required capital charges from 100 percent to 10 percent, or extend the time periods under which broker-dealers must collect margin would significantly undermine the risk-reducing objective of the current rule and diminish investor protection.[225]

Overall, the Commission believes the flexibility created by the proposed rule change with the optional capital charge will further alleviate the competitive burdens on small broker-dealers, including women, minority and veteran-owned firms, compared to larger broker-dealers and banks, while ensuring a broker-dealer collects margin or sets sufficient capital aside to cover the unsecured counterparty exposure in Covered Agency Transactions. The Commission believes that any limited competitive burdens placed on small broker-dealers are reasonable in light of the benefits the rule provides by strengthening the financial condition of the broker-dealer and addressing the risk of unsecured credit exposures in the Covered Agency Transaction market. Consequently, the Commission believes that the proposed rule change to permit broker-dealers to take a capital charge in lieu of collecting the excess net mark to market loss, which builds on the exceptions in the current rule to mitigate the impact of the proposed rule change on smaller broker-dealers, would further the purposes of the Exchange Act as it is reasonably designed to protect investors and the public interest.

3. Streamlining and Consolidation of Rule Language; Conforming Revisions

As discussed above in section II.C., FINRA proposed several amendments designed to streamline and consolidate the rule language and make conforming revisions in support of the proposed amendments regarding the elimination of the two percent maintenance margin

---

225 See section III.F.3. below (discussing other suggestions by commenters that would undermine the objectives of the rule to reduce the risk of unsecured credit exposures to Covered Agency Transactions and to encourage the collection of margin).

requirement, and the option to take a capital charge in lieu of collecting margin.[226] For example, FINRA proposes to delete the Supplemental Material related to monitoring mortgage banker counterparties because they were treated as exempt accounts under the current rule. Because the proposed rule change does not distinguish between exempt and non-exempt accounts, this Supplemental Material is redundant and FINRA proposed to delete it.[227]

The Commission did not receive comments on the proposed streamlining, consolidating and conforming amendments. The Commission believes the proposed rule change to streamline, consolidate, and conform the current rule text to reflect the proposed rule changes is appropriate in light of the elimination of the two percent maintenance margin requirement, and the addition of the optional capital in lieu of margin charge. The conforming amendments to the current rule will align the rule text to reflect the proposed rule changes and, in turn, create operational efficiencies and reduce costs for broker-dealers. For example, the proposed rule text clarified the language with respect to the $250,000 mark to market loss, thereby making it easier to determine the applicable margin amount.[228] This is expected to reduce costs in determining the required margin when a broker-dealer establishes a trading relationship with a counterparty.

Overall, the amendments to the proposed rule change, as modified by Amendment No. 1 (2021), to streamline, consolidate, and conform the rule text language will promote efficiency for broker-dealers and facilitate trading in the Covered Agency Transaction market.

B. The 2021 Amendments Should Reduce Potential Liquidations and Counterparty and Dealer "Chains" of Fails

1. Comments Received on Proposal

---

226 See Notice, 86 FR at 28165-28166.

227 See Notice, 86 FR at 28166.

228 See Notice, 86 FR at 28168.

Commenters expressed concern about requirements to liquidate Covered Agency Transactions stating that market participants often engage in long "chains" of Specified Pool or CMO transactions, where the initial seller contracts to sell a Specified Pool or CMO to the initial buyer, the initial buyer contracts to sell the Specified Pool or CMO to a second buyer, who contracts to sell it to a third buyer, etc.[229] The commenters stated that if any party in the chain (except for the last buyer) terminates its purchase or sale transaction, the buyer in the terminated transaction is unlikely to be able to buy the Specified Pool or CMO elsewhere, and therefore will be unable to perform on its sale transaction – and so will every subsequent buyer and seller in the chain. These commenters also stated that FINRA should eliminate or suspend the liquidation requirement under the proposed rule change to avoid the prospect of a "daisy chain" of fails.[230]

In the Petition for Review, Petitioners stated that they believe FINRA's responses failed to adequately address the substance of their objection that the proposed rule change creates a new and untenable counterparty risk, i.e., the risk that a transaction will fail because of a failure of another transaction elsewhere in a chain of transactions.[231] Petitioners also believed the proposed rule change will result in counterparties posting margin on the same underlying security in a chain resulting in a drain on liquidity.[232] Petitioners also reiterated their concerns that market participants will be reluctant to engage in Covered Agency Transactions if uncertainties exist as to whether FINRA will grant extensions of time related to liquidations, and under what standards FINRA uses to grant them.[233] Petitioners also continued to raise concerns

---

229 See Brean Capital Letter at 12-13, 20; SIFMA Letter at 3.

230 See Brean Capital Letter at 12-13; SIFMA Letter at 3.

231 See Petition for Review at 35-36.

232 See Petition for Review at 37.

233 See Petition for Review at 38.

about the ability of a broker-dealer and a counterparty to resolve valuation disputes within five business days.[234]

2. FINRA's Response to Comments

FINRA responded that, under the current rule, if a counterparty's unmargined net mark to market loss (and two percent maintenance margin deficiency, where applicable) exceeds $250,000 and is not margined or eliminated within five business days from the date it arises, the member is required to liquidate the counterparty's positions to satisfy the mark to market loss (and two percent maintenance margin deficiency, where applicable), unless FINRA specifically grants additional time. The proposed rule change eliminates this liquidation requirement.[235]

In addition, FINRA stated that, under the proposed rule change, a member can opt to take a capital charge in lieu of collecting margin to cover a counterparty's excess net mark to market loss. FINRA stated that if these capital charges[236] exceed the 25% TNC / $30MM Threshold for five consecutive business days, then the member:

- May not enter into new Covered Agency Transactions with non-margin counterparties other than risk reducing transactions;
- Must, to the extent of its rights, promptly collect margin for each counterparty's excess net mark to market loss; and
- Must, to the extent of its rights, promptly liquidate the Covered Agency Transactions of any counterparty whose excess net mark to market loss is not margined or eliminated

234 See Petition for Review at 38.

235 See Amendment No. 1 (2021) at 9.

236 As discussed in more detail in section II.B. above, FINRA stated that it is modifying the proposed rule change so that capital charges for a counterparty's unmargined excess net mark to market loss do not count toward the 25% TNC / $30MM Threshold to the extent that the member, in good faith, expects such excess net mark to market loss to be margined by the close of business on the fifth business day after it arose. See Amendment No. 1 (2021) at 10.

within five business days from the date it arises, unless FINRA has specifically granted the member additional time.[237]

Moreover, FINRA stated that if the member does not have the right to liquidate a counterparty's Covered Agency Transactions, the proposed rule change does not require the member to liquidate those transactions, even after the member has exceeded the 25% TNC / $30MM Threshold for five business days.[238] However, according to FINRA, if the member has exceeded the 25% TNC / $30MM Threshold for five business days and the member does have a right to liquidate a counterparty's Covered Agency Transactions and the counterparty's excess net mark to market loss has not been margined or eliminated within five business days, only then would a member be required to enforce its liquidation right or obtain an extension from FINRA.[239]

FINRA has also stated that this limited liquidation obligation should not lead to a daisy chain of fails, except possibly in circumstances where a counterparty's unwillingness or inability to perform its undisputed obligations makes it equally likely that a daisy chain of fails will occur whether or not the member liquidates a transaction with the counterparty.[240] According to FINRA, there are four categories of reasons why a counterparty would fail to margin its excess

---

237 See Amendment No. 1 (2021) at 10; FINRA Statement at 36.

238 FINRA stated that a member is not required to have a right to liquidate a counterparty's Covered Agency Transactions. However, 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 proposed rule change 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 proposed rule change and that the member's capital charges in lieu of margin on Covered Agency Transactions for all accounts combined will not exceed $25 million. According to FINRA, these procedures would likely involve limitations on the extent of the member's business with its non-margin counterparties. FINRA stated that when a broker-dealer'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. See Amendment No. 1 (2021) at 10.

239 See Amendment No. 1 (2021) at 10; FINRA Statement at 36.

240 See Amendment No. 1 (2021) at 10-11; FINRA Statement at 36.

net mark to market loss by the fifth business day after it arises, and FINRA stated that it believes only one of them has any prospect of leading to a liquidation requirement under the proposed rule change:

- First Category – The counterparty is a non-margin counterparty, i.e., the counterparty may not have an obligation, under a written agreement or otherwise, to margin its excess net mark to market losses within five business days after they arise. In this case, the member would not have a right under a written agreement or otherwise to liquidate the counterparty's Covered Agency Transactions when excess net mark to market losses are not margined or eliminated within five business days after they arise, and so would have no obligation or right under the proposed rule change to liquidate the counterparty's Covered Agency Transactions.[241]
- Second Category – An operational issue may cause the counterparty to fail to satisfy its obligation to margin its excess net mark to market losses. FINRA believes that five business days should be more than enough time to resolve any operational issue. However, in the event an extended operational issue, or series of operational issues, prevents a counterparty from providing margin for its excess net mark to market loss within five business days after it arises, a 14-day extension can be obtained from FINRA if the member has exceeded the 25% TNC / $30MM Threshold for five consecutive business days and would otherwise be under an obligation to enforce a right to liquidate the counterparty's Covered

241 See supra note 238 (stating that when a broker-dealer'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).

Agency Transactions. FINRA expects that an operational issue should not continue long enough to prevent a counterparty from satisfying its margin obligation past the expiration of a 14-day extension.[242]

- Third Category – There may be a disagreement over the amount of the counterparty's excess net mark to market loss, leading the counterparty to believe that it has satisfied its obligation to provide margin but the firm to believe that it has not. Commenters suggested that relatively unique assets, like Specified Pools and CMOs, are more likely to be the subject of valuation disputes. FINRA stated that five business days should be more than enough time to resolve any valuation dispute. Firms whose business involves a significant volume of transactions that are prone to valuation disputes should analyze whether their risk management procedures should require their contracts for such transactions to include or incorporate a procedure for the prompt resolution of valuation disputes.[243] FINRA stated that if an extended valuation dispute leads a counterparty to fail to provide margin for its excess net mark to market loss within five business days after it arises, a 14-day extension can be obtained from FINRA if the member has exceeded the 25% TNC / $30MM Threshold for five consecutive business days and would otherwise be under an obligation to enforce a right to liquidate the

242 See Amendment No. 1 (2021) at 11.

243 FINRA stated, by way of example, the current Credit Support Annex to the ISDA Master Agreement contains a provision under which the parties generally agree to resolve disputes over the valuation of over-the-counter ("OTC") derivatives for margin purposes by seeking four actual quotations at mid-market from third parties and taking the average of those obtained. FINRA stated that the OTC derivatives documented under ISDA Master Agreements can be much more difficult to value than any Specified Pool or CMO transaction. See Amendment No. 1 (2021) at 11-12.

counterparty's Covered Agency Transactions. FINRA stated that a margin valuation dispute should not continue past the expiration of a 14-day extension.[244]

- Fourth Category – The counterparty may be unwilling or unable to satisfy an undisputed obligation to margin its excess net mark to market loss. FINRA believes that, when a counterparty is unwilling or unable to satisfy its undisputed margin obligations, there is also reason for significant doubt that the counterparty would be willing and able to satisfy its obligations to pay or deliver on the settlement date of the transaction. When facing such an unreliable counterparty, FINRA stated that it believes it is possible the daisy chain of fails may occur even if the member does not liquidate. FINRA further stated that the daisy chain of fails could be just as easily triggered by the counterparty's unwillingness or inability to perform its obligations as by the member's liquidation of its transaction.[245]

According to FINRA, with regard to this fourth category, to the extent feasible, members should terminate transactions with such counterparties in order to protect themselves against further exposure. However, FINRA stated that if a member believes that it would not be feasible to terminate a transaction with such a counterparty, or that such termination would be unduly disruptive to the member's business or the market, extensions may be available from FINRA if the member has exceeded the 25% TNC / $30MM Threshold for five consecutive business days

244 See Amendment No. 1 (2021) at 11-12.

245 See Amendment No. 1 (2021) at 12.

and the member would otherwise be under an obligation to enforce a right to liquidate the counterparty's Covered Agency Transactions.[246]

According to FINRA, as described above, in the first category, members have no liquidation obligation under the proposed rule change. In the second and third categories, FINRA believes that the reason why the counterparty has not margined its excess net mark to market loss should be eliminated before the five business day period has ended, and generally before the expiration of a 14-day extension from FINRA.[247]

Further, in response to the Petition for Review, FINRA stated that Petitioners suggest that the requirement for multiple parties in a chain of Covered Agency Transaction to collect margin or take a capital charge is a flaw.[248] FINRA, however, stated that the proposed rule is designed to protect FINRA members against the risk of counterparty default.[249] In that context, FINRA stated that a given broker-dealer is not protected by the fact that another broker-dealer "up the chain" has already collected margin or taken a capital charge.[250] Rather, that broker-dealer is exposed to the contractual obligation to buy the securities on the settlement date and the credit risk that its counterparty will default on such purchase.[251] FINRA stated that these transactions are not riskless, and the requirement that each FINRA member manage that risk by collecting margin or taking a capital charge is necessary for the safeguards in the Covered Agency

---

246 FINRA stated that although an initial 14-day extension will be granted upon application citing the applicable circumstances, any application for a lengthy extension, or series of extensions, must describe the reason for the request and the member's plans for protecting itself (now and in the future) against the risk posed by a counterparty that has demonstrated itself to be unwilling or unable to perform its undisputed obligations. See Amendment No. 1 (2021) at 12.

247 See Amendment No. 1 (2021) at 13.

248 See FINRA Statement at 42.

249 See FINRA Statement at 42.

250 See FINRA Statement at 42.

251 See FINRA Statement at 42-43.

Transaction margin regime to work.[252] Further, in response to the Petition for Review, FINRA stated that Petitioners overstate the risk of a daisy chain of fails.[253] FINRA reiterated that it believes that the only reasonable circumstance in which liquidation would be required under the proposal is one in which the broker-dealer has a contractual right to liquidate the transaction and the counterparty is unwilling or unable to post collateral.[254] FINRA stated that in these circumstances the risk of default is particularly acute, that it is prudent in those circumstances to require the member to liquidate the position, and that it is likely that there would be a "daisy chain failure" regardless of the liquidation requirement because the counterparty would likely be unable to pay or deliver on the Covered Agency Transaction's settlement date.[255] FINRA stated that, on balance, the benefits of the margin requirement outweigh a risk that is only likely to manifest in a scenario that raises a high probability of the very type of default that the margin requirements are designed to protect against is a valid and reasonable conclusion. Finally, in response to the Petition for Review, FINRA stated that the proposed 25% TNC / $30MM Threshold is intended to limit FINRA members' risk exposure, with the goal of ensuring that a counterparty default does not cause a firm to fail and therefore to be unable to meet its obligations to customers and counterparties.[256]

3. Commission Discussion and Findings

The Commission agrees with FINRA that the probability of a liquidation causing a chain of fails would most likely occur when a counterparty to a Covered Agency Transaction cannot or

252 See FINRA Statement at 43.

253 See FINRA Statement at 36.

254 See FINRA Statement at 36.

255 See FINRA Statement at 36-37.

256 See FINRA Statement at 37.

will not meet a margin call, and that such a counterparty would likely be in default at settlement regardless of any liquidation requirement. The proposed rule change will provide broker-dealers the flexibility to collect margin for the excess net mark to market loss from a counterparty to a Covered Agency Transaction or take a capital charge in lieu of collecting the margin, subject to specified terms and conditions. A broker-dealer that employs the capital charge option—because it does not require the counterparty to post margin—eliminates the potential risk of a "daisy chain" of fails arising from the broker-dealer needing to liquidate a position of the counterparty for failing to post required margin.

Further, the current rule requires a broker-dealer to collect variation and/or maintenance margin from every counterparty unless there is an exception, and liquidate a Covered Agency Transaction after five business days if they fail to collect required margin. The proposed rule change eliminates this requirement and instead proposes a more limited requirement to liquidate a counterparty's position in cases where the member has the contractual right to liquidate a counterparty's Covered Agency Transactions. The elimination of the two percent maintenance margin requirement also will reduce margin posting requirements of counterparties and, therefore, reduce the likelihood that a counterparty will fail to provide required margin in a manner that triggers the liquidation requirement. Under the proposed rule change, the requirement to liquidate a transaction will be triggered if: (1) the counterparty or product is not subject to any exceptions (including the $250,000 mark to market exception); (2) the broker-dealer has the contractual right to liquidate the transaction; (3) the 25% TNC / $30MM Threshold has been exceeded for five business days; and (4) FINRA has not granted any extensions. Thus, the liquidation requirement generally will be triggered in limited

circumstances and, as discussed above, when those circumstances arise it is likely that the chain of fails would occur irrespective of the liquidation requirement.

With respect to concerns regarding whether FINRA will grant extension requests related to liquidations (if a broker-dealer has a right to liquidate a transaction and has exceeded the 25% / $30MM Threshold for five business days), including cases where there is a valuation dispute,[257] FINRA has indicated that an initial 14-day extension will be granted upon an application that describes the reasons for the extension request.[258] FINRA also has previously addressed these concerns in its Frequently Asked Questions and Guidance for Covered Agency Transactions under Rule 4210 ("FAQs") issued for the current rule.[259] The ability to receive extensions of time beyond the five business day period will help to protect broker-dealers where liquidation is infeasible or would unduly disrupt the FINRA member's business or the markets.[260] These extension procedures are consistent with longstanding practice and guidance for margin extensions under Rule 4210.

C. FINRA has Appropriately Responded to the Comments Regarding Introducing and Clearing Firm Matters

1. Comments Received on Proposal

---

257 One way to reduce the potential risks arising from valuation disputes is for a broker-dealer to incorporate procedures for resolving valuation disputes in margin agreements with counterparties. See Amendment No. 1 (2021) at 11-12.

258 Any application for a lengthy extension, or series of extensions, must describe the reason for the request and the member's plans for protecting itself (now and in the future) against the risk posed by a counterparty that has demonstrated itself to be unwilling or unable to perform its undisputed obligations. See supra note 246.

259 These FAQs (Frequently Asked Questions & Guidance: Covered Agency Transactions Under FINRA Rule 4210) are available at www.finra.org. FINRA has stated that the FAQs will be updated following approval of the proposed rule change. See section III.D.8. below. The electronic system to request extensions of time is FINRA's Regulatory Extension system or REX system. FINRA has previously indicated in its FAQs that it will update the REX system to accommodate broker-dealers' requests for extensions of time related to Covered Agency Transactions, and that it will announce an online education tool on how to use the REX system for extension requests in connection with such transactions. See, e.g., FINRA FAQs 8 through 10.

260 See Amendment No. 1 (2021) at 12-13.

Commenters stated the proposed rule change does not address the role of clearing firms or reflect that FINRA has considered the actual way in which introducing brokers clear trades in Covered Agency Transactions.[261] One commenter expressed concern about the costs of implementing the proposed rule change and stated the rule would be difficult to administer without the direct participation and support of clearing firms.[262] Another commenter suggested that FINRA continue to facilitate dialogue among introducing and clearing firms.[263]

Further, introducing broker-dealers stated that the proposed amendments could result in requirements for firms to post margin to clearing firms under a contractual arrangement, in addition to taking capital charges because they do not or cannot enter into margin agreements with their counterparties. They stated that this scenario would double the financial obligations to these firms with respect to Covered Agency Transactions.[264]

Further, in response to the 2022 Approval Order, Petitioners stated that neither FINRA nor the Division staff analyzed how FINRA's margin requirements would interact with the contractual requirements that clearing firms impose, and stated that they believe an after-the-fact promise to fix a problem with the original rulemaking is not an argument for approving the proposed rule change.[265] The Petitioners stated that Amendment No. 1 (2021) to the proposed

---

261 See Brean Capital Letter at 13. For example, commenters stated that many regional broker-dealers cannot receive margin even if a customer posts it with a clearing firm, since the proposal does not provide a mechanism by which an introducing broker will receive a credit for collecting margin if the customer deposits the margin with the clearing broker. See BDA and Brean Capital Letter at 35-36; Petition for Review at 39; BDA Small Firms Letter at 2.

262 See Stephens Letter at 3.

263 See SIFMA Letter at 3.

264 See Duncan-Williams/SouthState Letter at 3; Petition for Review at 34; BDA Small Firms Letter at 3.

265 See Petition for Review at 34-35.

rule change did not reference any data supporting that collateral a clearing firm currently collects is insufficient to protect against the risk the proposed rule change seeks to address.[266]

2. FINRA's Response to Comments

FINRA responded to the comments regarding clearing firms by stating that it has conducted extensive dialogue with introducing and clearing firms regarding the requirements of the current rule and the proposed rule change in the context of introducing and clearing arrangements, and such dialogue informed several of the proposed rule change's clarifying changes to the original rulemaking.[267] Further, FINRA stated that it intends to continue to facilitate discussions with introducing and clearing firms as it implements the proposed rule change.[268]

In addition, FINRA stated, in response to the comment in the Petition for Review that it failed to account for the fact that clearing firms already collect margin for Covered Agency Transactions from introducing firms, that this comment undermines the Petitioners' arguments that margining Covered Agency Transactions is unnecessary.[269]

3. Commission Discussion and Findings

The fact that a clearing firm collects margin for Covered Agency Transactions from its introducing firms under a contractual agreement highlights the importance of protecting broker-dealers against the risk of unsecured credit exposures in the Covered Agency Transaction market through the collection of margin or capital charges. The proposed rule provides broker-dealers with the flexibility to take a capital charge in lieu of collecting the excess net mark to market loss

266 See Petition for Review at 39.

267 See Amendment No. 1 (2021) at 20.

268 See Amendment No. 1 (2021) at 20.

269 See FINRA Statement at 39.

from a counterparty; it is does not prescribe any new margin collection requirements. Where it chooses to collect margin, a broker-dealer would collect margin from its counterparty consistent with other margin requirements in FINRA Rule 4210. The proposed rule change, consistent with other Rule 4210 requirements, does not address the margin or other contractual requirements that a clearing firm may impose on its introducing firms, or the requirements that such firms must comply with under current FINRA rules. For example, FINRA Rule 4311 governs carrying and clearing firm arrangements, including allocations of responsibility with respect to extensions of credit.[270]

Finally, FINRA's response is appropriate that it will continue to engage in dialogue with introducing firms and clearing firms in implementing the proposed rule change.[271] This is consistent with other proposed rule changes where FINRA answered questions or provided further guidance to market participants regarding implementation of new rules.[272]

D. FINRA's Reponses to Other Comments, Requests for Clarifications; and Technical Revisions to the Proposed Rule Change are Appropriate and Consistent with the Exchange Act

In response to the Notice and the 2021 Order Instituting Proceedings commenters raised additional matters regarding other aspects of the proposed rule change or requested clarifications or technical revisions to the proposed rule change, as modified by Amendment No. 1 (2021). These comments, FINRA's response to comments, and the Commission's discussion and findings are set forth below.

---

270 See FINRA Rule 4311 and Covered Agency Transactions FAQs at www.finra.org.

271 See, e.g., section III.D.8. below (discussing FAQs).

272 See, e.g., FINRA Rules & Guidance/Interpreting the Rules, available at: https://www.finra.org/rules-guidance/interpreting-rules.

1. Definition of "Net Mark to Market Loss" and Use of Phrase "Legally Enforceable Netting Agreement" in the Definition of "Net Mark to Market Loss"

A commenter requested confirmation that the definition of "net mark to market loss" would include the calculations utilized under the MSFTA form SIFMA publishes.[273] In addition, Petitioners requested that FINRA identify which party is responsible for marking securities to market.[274] In response, FINRA stated that it does not require or endorse any particular form of agreement for margining Covered Agency Transactions, and as such, declines to provide the requested confirmation because it relates to a commercial matter between the parties.[275]

A commenter also suggested that FINRA should remove the phrase "legally enforceable right of offset or security" from the definition of "net mark to market loss."[276] In response to this suggestion, FINRA stated that this phrase is necessary.[277] FINRA stated that, if the phrase is removed, then the amount of the counterparty's mark to market losses which are subject to margining would be reduced by the counterparty's mark to market gains on other transactions, without regard to whether the member has any legally enforceable right to apply those gains to cover the counterparty's losses. FINRA stated, for example, that if a counterparty defaults when it has a mark to market loss of $10 million on one transaction, and a mark to market gain of $10 million on another transaction, having a legally enforceable right of offset would allow the

---

273 See SIFMA Letter at 4.

274 See Petition for Review at 38-39; Stephens Letter at 2-3 (stating that larger firms have an advantage in dictating the terms when determining the price in calculating margin).

275 See Amendment No. 1 (2021) at 14. Similarly, FINRA stated that it also declines a commenter's request to confirm that an MSFTA with a cure period (or similar provision after the expiration of which liquidating action may be taken) of less than or equal to five business days would provide the rights described in the definition of "non-margin counterparty" under paragraph (e)(2)(H)(i)e. under the proposed rule change. See Amendment No. 1 (2021) at 14 and SIFMA AMG Letter at 4.

276 See SIFMA Letter at 4.

277 See Amendment No. 1 (2021) at 14.

member to apply the counterparty's gains to cover its losses. In the absence of a legally enforceable right of offset or security, however, FINRA stated that the member could have an obligation to pay the counterparty $10 million for its gains, without any guaranty of collecting the full amount of the counterparty's $10 million loss. If the counterparty enters insolvency proceedings, the lack of a legally enforceable right of offset or security could result in the member being obliged to pay the full $10 million of the defaulted counterparty's gains and only collecting cents on the dollar for the counterparty's losses.[278]

In addition, one commenter requested confirmation that the phrase "first-priority perfected security interest" applies only to pledges of Covered Agency Transactions with third parties rather than to margin cash or securities posted to the broker-dealer.[279] In response, FINRA stated that the phrase "first-priority perfected security interest" in paragraph (e)(2)(H)(i)d.2. under the proposed rule change only applies to pledges of a counterparty's rights under Covered Agency Transactions with third parties.[280]

In response to the comments about SIFMA's MSFTA form, the Commission agrees that FINRA appropriately responded that the proposed rule change does not require any specific form, agreement, or contract for margining Covered Agency Transactions. Each FINRA member and its counterparty may agree to use a particular form or agreement. This practice is consistent with other provisions of Rule 4210 that do not specify which party is responsible for calculating the mark to market gain or loss.

Further, the Commission agrees with FINRA that retaining the phrase "legally enforceable right of offset or security" in the definition of net mark to market loss is appropriate

---

278 See Amendment No. 1 (2021) at 14.

279 See SIFMA Letter at 4.

280 See Amendment No. 1 (2021) at 14-15.

because it will allow a FINRA member to apply the counterparty's gains to cover its losses only when there is a legally enforceable right to do so, which will reduce a broker-dealer's financial exposure to a counterparty in the event of insolvency. This will provide more certainty as to which transactions are nettable in the event of a counterparty's insolvency. If broker-dealers were permitted to net transactions from different counterparties where there is no legal right to do so, it would increase the risk under the proposed rule change that the broker-dealer would be exposed to additional losses in the event of a counterparty default. This result would undermine the effectiveness of the proposed rule change to reduce the risk of unsecured exposures in the Covered Agency Transaction market. Finally, FINRA's clarification with respect to the phrase "first-priority perfected security interest" is appropriate because FINRA clarified that it only applies to pledges of a counterparty's rights under Covered Agency Transactions with third parties. This clarification will assist broker-dealers and their counterparties in complying with the amendments under the proposed rule change.

2. Definition of "Excess Net Mark to Market Loss"

Some commenters requested confirmation from FINRA that broker-dealers would only be required to collect the excess net mark to market loss (or take capital charges for such amount subject to specified terms and conditions) to cover the amount by which a counterparty's net mark to market loss exceeds $250,000.[281]

In response to this request for confirmation, FINRA stated that the commenters are correct. According to FINRA, under the proposed rule change, paragraph (e)(2)(H)(ii)c. of FINRA Rule 4210 states the rule does not require members "to collect margin, or take capital charges, for counterparties' mark to market losses on Covered Agency Transactions other than

[281] See SIFMA Letter at 4; SIFMA AMG Letter at 4.

excess net mark to market losses" and a counterparty's "excess net mark to market losses" are defined in paragraph (e)(2)(H)(i)c. as "such counterparty's net mark to market loss to the extent it exceeds $250,000."[282] FINRA stated that, for example, if a member's counterparty has a net mark to market loss of $300,000, its excess net mark to market loss is $50,000, which would be the amount of margin the proposed rule change would require the member to collect, or take a capital charge in lieu of collecting (unless there is an applicable exemption). FINRA stated that the counterparty's excess net mark to market loss is the minimum amount of margin that (subject to the exceptions) the member must collect (or take a capital charge in lieu of collecting). FINRA also stated that the proposed rule change does not prevent members and their counterparties from agreeing that the counterparty will transfer additional margin.[283]

One commenter requested that FINRA clarify that broker-dealers may elect to treat the $250,000 as a minimum transfer amount (and collect the entire market to market loss once it exceeds $250,000), rather than a threshold below which the first $250,000 of the mark to market loss does not need to be collected.[284] In response to this comment, FINRA stated that if a member has a right under a written agreement to collect margin for a counterparty's entire net mark to market loss whenever the amount of that loss exceeds $250,000, for purposes of the proposed rule change, it would view this as a right under a written agreement to collect margin for such counterparty's excess net mark to market loss, since the counterparty's excess net mark to market loss is $250,000 less than the counterparty's entire net mark to market loss (or zero if the net mark to market loss does not exceed $250,000).[285]

---

282 See Amendment No. 1 at 13.

283 See Amendment No. 1 (2021) at 13-14.

284 See SIFMA AMG Letter at 4.

285 See Amendment No. 1 (2021) at 15.

FINRA's responses are consistent with the definition of "excess net mark to market loss" in the proposed rule change, i.e., that broker-dealers must collect the margin amount in excess of $250,000 or take a capital charge in lieu of collecting the excess net mark to the market loss. Further, broker-dealers also may agree with a counterparty to collect margin above the rule's requirements (i.e., collect the first $250,000 of the mark to market loss and treat the amount as a minimum transfer amount), which will further protect the broker-dealer from counterparty credit risk.

3. Definition of "Non-Margin Counterparty"

Under the proposed rule change, with respect to the five business day period, paragraph (e)(2)(h)(i)e.1. of FINRA Rule 4210 provides in part that a counterparty is a non-margin counterparty if the member "does not have a right under a written agreement or otherwise to collect margin for such counterparty's excess net mark to market loss and to liquidate such counterparty's Covered Agency Transactions if any such excess net mark to market loss is not margined or eliminated within five business days from the date it arises."[286] A commenter stated that this proposed rule text effectively requires imposing a margin collection timing which is stricter than required under other rules or the standard under paragraph (f)(6) of FINRA Rule 4210.[287]

In response to this comment, FINRA stated that it disagrees for several reasons. First, FINRA stated that current rule requires a broker-dealer to liquidate positions whenever a mark to market loss (or maintenance deficiency) on Covered Agency Transactions is not margined or otherwise eliminated within five business days (and no extension has been obtained).[288] FINRA

---

286 See Amendment No. 1 (2021) at 15.

287 See SIFMA Letter at 4.

288 See Amendment No. 1 (2021) at 15.

stated that the proposed rule change uses a five business-day period but applies it more flexibly than under the current rule.[289]

FINRA stated that if a member does not have a right under a written agreement or otherwise to collect margin for such counterparty's excess net mark to market loss and to liquidate such counterparty's Covered Agency Transactions if any such excess net mark to market loss is not margined or eliminated within five business days from the date it arises, that counterparty is a "non-margin counterparty."[290] As consequence, the member must take capital charges in cases where it is not collecting margin for a non-margin counterparty, and the member would become subject to the enhanced risk management requirements under the rule which requires firms with non-margin counterparties to establish and enforce risk management procedures reasonably designed to ensure that the capital charges in lieu of collecting margin do not exceed $25 million, and promptly notify FINRA if the amount of specified net capital charges exceeds $25 million for five consecutive business days.[291] FINRA stated that the proposed rule also requires that if the member's specified net capital deductions exceed the 25% TNC / $30MM Threshold for five consecutive business days, the member would not be able to enter into transactions with a non-margin counterparty, other than risk reducing transactions, while those net capital deductions continue to exceed the threshold.[292] FINRA stated that if the member has a right to liquidate a counterparty's Covered Agency Transactions if the counterparty's excess net mark to market loss is not margined or eliminated within five business days, the member is not required to enforce that right (that is, not required to liquidate the

289 See Amendment No. 1 (2021) at 15.

290 See Amendment No. 1 (2021) at 15.

291 See Amendment No. 1 (2021) at 15-16.

292 See Amendment No. 1 (2021) at 16.

counterparty's Covered Agency Transactions), unless and until the member's specified net capital deductions exceed the 25% TNC / $30MM Threshold for five consecutive business days (and the member has not obtained an extension from FINRA).[293]

Second, FINRA stated that even if members were required to have a contractual right to liquidate when margin is not collected within five business days, that would not, in the commenter's terms, "impos[e] a margin collection timing that is stricter than that which is required under the rules (or other aspects of FINRA Rule 4210 generally)" because paragraph (f)(6) of FINRA Rule 4210 requires margin to be collected "as promptly as possible," and the rule as approved pursuant to the original rulemaking (as stated above) requires liquidation when a mark to market or maintenance deficiency has not been margined or eliminated within five business days (unless an extension has been obtained).[294]

The Commission agrees with FINRA's response to the comment that the reference to a five business-day requirement in the definition of non-margin counterparty effectively imposes a margin collection-timing requirement that is stricter than under current margin rules. A counterparty is a non-margin counterparty under the proposed rule change if the broker-dealer does not have a right under a written agreement or otherwise to collect margin for such

---

293 See Amendment No. 1 (2021) at 16. Further, FINRA stated that classification of a counterparty as a non-margin counterparty depends on (a) whether the member has the right to collect margin for the counterparty's excess net mark to market loss, (b) whether the member regularly collects margin for the counterparty's excess net mark to market loss, and (c) whether the member has the right to liquidate such counterparty's Covered Agency Transactions if the counterparty's excess net mark to market loss is not margined or eliminated within five business days from the date it arises. According to FINRA, classification of a counterparty as a margin counterparty (that is, as not a non-margin counterparty) does not require the member to exercise the right to liquidate whenever that counterparty's excess net mark to market loss is not margined or eliminate within five business days. However, FINRA stated that the counterparty would need to be reclassified as a non-margin counterparty if the member does not regularly collect margin for the counterparty's excess net mark to market loss. FINRA stated that the exercise of the right to liquidate is only required by the proposed rule change if the member's capital charges have exceeded the 25% TNC / $30MM Threshold for five consecutive business days (and the member has not obtained an extension from FINRA). See Amendment No. 1 (2021) at 16 and SIFMA Letter at 4-5.

294 See Amendment No. 1 (2021) at 16-17.

counterparty's excess net mark to market loss and to liquidate such counterparty's Covered Agency Transactions if any such excess net mark to market loss is not margined or eliminated within five business days from the date it arises. The five business day reference in the definition of non-margin counterparty is used to classify counterparties as non-margin counterparties for purpose of the proposed rule change. The reference does not impose a five-day margin collection requirement. Therefore, it does not impose a margin requirement stricter than under current rules.

Further, the current rule contains a liquidation requirement if a mark to market loss (or maintenance deficiency) on Covered Agency Transactions is not margined or otherwise eliminated within five business days (and no extension has been obtained). The proposed rule eliminates this requirement and permits greater flexibility with respect to whether a broker-dealer must liquidate a counterparty's positions if it has a right to do so (i.e., only after certain conditions occur and if no extensions of time have been obtained). Therefore, the reference to five business days in the term non-margin counterparty in the proposed rule changes does not effectively impose a margin collection or liquidation requirement whenever that counterparty's excess net mark to market loss is not margined or eliminated within five business days.

4. Exclusion of Exempted Counterparties from Definition of Non-Margin Counterparty

A commenter suggested that FINRA explicitly exclude small cash counterparties and other exempted counterparties covered by paragraph (e)(2)(H)(ii)a.1. of FINRA Rule 4210 under the proposed rule change from the definition of "non-margin counterparty."[295] FINRA stated

[295] See SIFMA Letter at 5.

that this request is consistent with the purpose of paragraph (e)(2)(H)(ii)a.1. and has modified the definition of "non-margin counterparty" to implement the requested exclusion.[296]

The Commission agrees with FINRA that the modification of the definition of "non-margin counterparty" to exclude small cash counterparties and certain other counterparties from the scope of the rule, except with respect to the written risk limit determinations, is appropriate as it alerts broker-dealers subject to the rule that small cash counterparties and other exempted counterparties are specifically excluded from the definition and therefore do not count toward the 25% TNC / $30MM Threshold.

5. Computation of the 25% TNC / $30MM Threshold

A commenter requested confirmation that margin not collected from small cash counterparties does not count toward the 25% TNC / $30MM Threshold.[297] In response to this comment, FINRA stated that margin not collected from small cash counterparties does not count toward the 25% TNC / $30MM Threshold.[298] Further, FINRA stated that paragraph (e)(2)(H)(ii)d.3. of FINRA Rule 4210 only counts capital charges under paragraph (e)(2)(H)(ii)d.1. toward the 25% TNC / $30MM Threshold. In addition, FINRA stated that, under the proposed rule change, paragraph (e)(2)(H)(ii)a.1. of FINRA Rule 4210 does not require members "to collect margin, or to take capital charges in lieu of collecting such margin, for a counterparty's excess net mark to market loss if such counterparty is a small cash counterparty, registered clearing agency, 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 for International Settlements." FINRA stated that because the proposed rule

296 See Amendment No. 1 (2021) at 17; Exhibit 4 to Amendment No. 1 (2021).

297 See SIFMA Letter at 5.

298 See Amendment No. 1 (2021) at 17.

change does not require members to take capital charges for these counterparties' unmargined excess net mark to market losses, they do not count toward the 25% TNC / $30MM Threshold.[299]

The Commission agrees with FINRA's response to the commenter's request for confirmation regarding whether margin not collected from small cash counterparties counts toward the 25% TNC / $30MM Threshold. FINRA's response appropriately addresses the commenter's concerns and it reflects the plain language of the proposed rule change. Finally, while small cash counterparties do not count toward the 25% TNC / $30MM Threshold, the proposed rule prescribes additional protection through overall concentration thresholds under paragraph (e)(2)(I) of FINRA Rule 4210.[300]

With respect to counterparties yet to post margin, a commenter suggested that the proposed rule change be modified so that any capital charge under paragraph (e)(2)(H)(ii)d.1. of FINRA Rule 4210 not count toward the 25% TNC / $30MM Threshold until the fifth business day after the relevant excess net mark to market loss arose.[301] The commenter stated that many counterparties that are regularly margined are unable to post margin on a consistent T+1 basis due, for example, to those counterparties being in an overseas jurisdiction, or to operational or custodial issues.[302] Moreover, the commenter stated good faith disputes over the amount of margin to be posted may mean that a counterparty does not post margin by T+1 even when the counterparty is ready, willing, and able to post margin promptly after the proper amount is

---

299 See Amendment No. 1 (2021) at 17.

300 See section II.B. above (discussing paragraph (e)(2)(I) of FINRA Rule 4210 under the proposed rule change).

301 See SIFMA Letter at 6. The proposed rule would require a capital charge whenever a counterparty's excess net mark to market loss is not margined or eliminated by the close of business on the business day after the business day on which it arises. See proposed paragraph (e)(2)(H)(ii)d.1. in Exhibit 5 to the proposal.

302 See SIFMA Letter at 5.

determined.[303] Finally, the commenter stated that, without a grace period, members may continuously exceed the 25% TNC / $30MM Threshold based on ordinary levels of margin not yet collected from counterparties who are expected to post required margin.[304]

In response to this comment, FINRA stated that the proposed rule change does not require counting toward the 25% TNC / $30MM Threshold capital charges taken for excess net mark to market losses that the member in good faith expects to be margined by the fifth business day after they arise.[305] Accordingly, FINRA proposed to revise paragraph (e)(2)(H)(ii)d.3. of FINRA Rule 4210 so that capital charges under paragraph (e)(2)(H)(ii)d.1. with respect to a counterparty's unmargined excess net mark to market loss do not count towards the thresholds in paragraph (e)(2)(H)(ii)d.3. to the extent that the member, in good faith, expects such unmargined excess net mark to market losses to be margined within five business days.[306] According to FINRA, members would still be required to protect themselves by taking net capital deductions while the excess net mark to market losses are unmargined, but, under the proposed rule change, as modified by Amendment No.1 (2021), will have more flexibility to address operational issues and valuation disputes before they impact the 25% TNC / $30MM Threshold.[307]

The proposed change related to the 25% TNC / $30MM Threshold is appropriate as it provides additional time and flexibility for member firms to address operational and related

---

303 See SIFMA Letter at 5.

304 See SIFMA Letter at 5-6.

305 See Amendment No. 1 (2021) at 18.

306 See Amendment No. 1 (2021) at 18. More specifically, FINRA has revised paragraph (e)(2)(H)(ii)d.3. of FINRA Rule 4210 to refer to a member's "specified net capital deductions" (rather than to all net capital deductions under paragraph (e)(2)(H)(ii)d.1.) and inserted the following definition into paragraph (e)(2)(H)(i): i. A member's "specified net capital deductions" are the net capital deductions required by paragraph (e)(2)(H)(ii)d.1. of this Rule with respect to all unmargined excess net mark to market losses of its counterparties, except to the extent that the member, in good faith, expects such excess net mark to market losses to be margined by the close of business on the fifth business day after they arose. Id.

307 See Amendment No. 1 (2021) at 18.

issues related to the collection of margin, thereby avoiding unnecessary disruptions to the Covered Agency Transaction market. The proposed change related to the 25% TNC / $30MM Threshold also enhances transparency with respect to the scope of transactions which count toward the threshold. This will enable broker-dealers to calculate the 25% TNC / $30MM Threshold more efficiently, which, in turn, may increase operational efficiencies for broker-dealers.

6. Requirement to Enforce Rights to Collect Margin and Liquidate Covered Agency Transactions

A commenter requested clarification with respect to the application of the requirement of paragraph (e)(2)(H)(ii)d.3. of FINRA Rule 4210 under the proposed rule change, which provides that a member whose specified net capital deductions exceed the 25% TNC / $30MM Threshold for five consecutive business days "shall also, to the extent of its rights, promptly collect margin for each counterparty's excess net mark to market loss and promptly liquidate the Covered Agency Transactions of any counterparty whose excess net mark to market loss is not margined or eliminated within five business days from the date it arises, unless FINRA has specifically granted the member additional time."[308] More specifically, FINRA stated these requirements apply once the member's specified net capital deductions exceed the 25% TNC / $30MM Threshold for five consecutive business days and cease as soon as those capital charges fall below that threshold. Accordingly, FINRA stated that once the member's specified net capital deductions fall below that 25% TNC / $30MM Threshold (for example, because of market movements, or because the member collects enough margin from some, but not all, of its counterparties), the member is under no further obligation to enforce its contractual rights to

[308] See SIFMA Letter at 5-6.

collect margin or liquidate Covered Agency Transactions (and could, if it chooses, rescind outstanding margin calls and halt any liquidations of its counterparties' Covered Agency Transactions).[309]

The Commission finds that FINRA's explanation addresses the commenter's request for clarification and enhances transparency with respect to the application of 25% TNC / $30MM Threshold. The Commission believes that FINRA's explanation also appropriately provides guidance with respect to a broker-dealer's ability to rescind outstanding margin calls and halt any liquidations of a counterparty's transactions if it chooses to do so, once the specified net capital deductions fall below the 25% TNC / $30MM Threshold.

7. Reporting by Members with Non-Margin Counterparties

FINRA stated that, pursuant to paragraph (e)(2)(H)(ii)d.4. of FINRA Rule 4210 under the proposed rule change, a member with non-margin counterparties would be required to "submit to FINRA such information regarding its unmargined net mark to market losses, non-margin counterparties and related capital charges, in such form and manner, as FINRA shall prescribe by Regulatory Notice or similar communication." A commenter indicated that the building of systems and information tracking is a significant build for many firms and requested FINRA to clarify in advance what information it may require.[310] In response to this comment, FINRA stated that it is considering what information it will require broker-dealers to submit and expects

309 See Amendment No. 1 (2021) at 19. FINRA also stated that a member, so long as it acts promptly to bring itself below the 25% TNC / $30MM Threshold, may choose the manner and order in which it enforces its rights to collect margin or liquidate Covered Agency Transactions, and may halt those actions once its specified net capital deductions fall below the 25% TNC / $30MM Threshold. Id.

310 See SIFMA Letter at 6.

to engage members and industry participants in developing appropriately tailored reporting pursuant to this provision.[311]

FINRA's response to the comment about the reporting by firms with non-margin counterparties is appropriate. FINRA is currently considering what information it will require and it expects to engage with member firms and industry participants in developing tailored reporting requirements. This engagement will provide industry participants the opportunity to provide input into the reporting requirements before FINRA announces them by Regulatory Notice or similar communication. The reporting requirements announced in a Regulatory Notice or similar communication will provide firms with advance notice with respect to what reporting FINRA will require to enable them to build out their systems to meet such requirements.

8. Status of Published FAQs

A commenter asked whether the Covered Agency Transactions FAQs[312] will apply if the Commission approves the proposed rule change.[313] FINRA responded that if the Commission approves the proposed rule change, FINRA would update the FAQs with Commission staff, members, and industry participants as appropriate.[314] FINRA's response to the comment related to the status of the FAQs appropriately confirms that FINRA would re-examine the application of the FAQs, as appropriate, if the Commission approves the proposal. With the approval of the proposal, FINRA will need to conform the FAQs to the rule, as amended by the proposal.

E. FINRA's Proposed Implementation Schedule for the Amended Margin Requirements is Appropriate and Consistent with the Requirements of the Exchange Act

311 See Amendment No. 1 at 19.

312 After the original rulemaking was approved, FINRA made available a set of FAQs and guidance clarifying certain of the requirements, available at: www.finra.org.

313 See SIFMA Letter at 6-7.

314 See Amendment No. 1 (2021) at 20.

1. Comments Received on Proposal

In response to the proposed rule change, several commenters requested that FINRA adopt an implementation period of at least 18 months after publication of a final rule before compliance is required, stating that a constrained time period for implementation could present market access risk, and citing the need to build operations and technology and to negotiate necessary documentation.[315] In response to Amendment No. 1 (2021), a commenter reiterated its previous comments requesting an implementation period of 18 months, or, in the alternative, an implementation timeframe of at least one year.[316]

Further, the Petitioners requested that the Commission clarify that the proposed rule change would under no circumstances take effect earlier than nine to ten months after the full Commission renders its final decision.[317] In requesting this clarification, the Petitioners stated that broker-dealers would require the full implementation period to bring their policies and procedures, as well as their back office systems and information technology infrastructure, into compliance.[318]

2. FINRA's Response to Comments

FINRA responded to these comments by stating it believes that the subject matter is well understood by member firms and industry participants. FINRA stated it would announce the effective date no later than 60 days following approval (if the Commission approves the

315 See SIFMA AMG letter at 1-3; SIFMA Letter at 2; BDA Letter at 5.

316 See Letter from Chris Killian, Managing Director, Securitization, Corporate Credit, Libor, SIFMA (Sept. 10, 2021) at 1-2. The comment letter was submitted jointly by SIFMA and SIFMA AMG.

317 See Petitioners' Statement at 2-3.

318 See Petitioners' Statement at 2.

proposed rule change) and would provide an effective date between nine and ten months following such approval.[319]

FINRA stated that an extended implementation timeframe of 18 months would undermine the objectives of the Covered Agency Transaction requirements. FINRA also stated that Covered Agency Transactions have been under discussion for a considerable time, both prior to and since approval of the 2016 Amendments. As a result, FINRA believes that the public interest would not be served by continuing to delay effective date, and that the timeframe set forth in Amendment No. 1 (2021) is appropriate.[320]

3. Commission Discussion and Findings

FINRA's proposed implementation schedule is appropriate and consistent with the requirements of the Exchange Act. FINRA member firms and industry participants are aware of the current requirements of the Covered Agency Transaction margin rule and have had time to work toward implementation. The proposed rule change eliminates the two percent maintenance margin requirements and the need for firms to monitor whether a counterparty is an exempt or non-exempt account under the rule. The proposed rule change also does not prescribe any new margin collection requirements; it is reducing regulatory burdens for broker-dealers by providing flexibility to broker-dealers to take a capital charge subject to specified terms and conditions in lieu of collecting the excess net mark to market loss. The modifications provided by the proposed rule change and the timeframe of nine to ten months as described in Amendment No. 1 (2021) will provide sufficient flexibilities and time for FINRA-member broker-dealers to come into compliance with the rule. Finally, in response to commenters requesting clarification

319 See Amendment No. 1 (2021) at 20.

320 See FINRA Letter at 7-8.

regarding the implementation timeframe of the proposed rule change, the implementation timeframe is measured starting from the time of the Commission's approval under this order.

F. Issues Relating to 2016 Amendments

1. This Order Relates only to the Commission's Review of the Division's Approval of the 2021 Amendments by Delegated Authority

a. Comments on the Proposal

As part of their comments on the proposed rule change, Petitioners requested that the Commission repeal the current rule approved by the 2016 Approval Order, except for the written risk limit determinations that are already implemented.[321] In addition, Petitioners requested that the Commission indefinitely delay the effectiveness of the current rule under SR-FINRA-2015-036 so that Covered Agency Transaction margin collection requirements would not apply to any broker-dealer.[322]

Several commenters also stated that proposed rule and the 2016 Amendments are designed for a market that settles on a T+2 basis,[323] and that the procedures for clearing and settling mortgage-backed security trades are forward looking and involve monthly closing dates

---

321 See Petition for Review at 45; SR-FINRA-2015-036 and 2016 Approval Order.

322 See Petitioners' Statement at 3-4. Petitioners stated that because the margin collection requirements set in the current rule approved under SR-FINRA-2015-036 have not been implemented and would take effect now only if the Commission approved the implementation schedule under review in SR-FINRA-2021-010, the Commission could prevent both the margin collection requirements under the current rule and the proposed rule change from taking effect simply by disapproving the proposed rule change. See Petitioners' Statement at 3, n.4.

323 See definition of Covered Agency Transaction in Exhibit 4 to Amendment No. 1 (2021). For example, the current rule and proposed rule change defines TBA transactions, as transactions defined in Rule 6710(u), inclusive ARM transactions, for which the difference between the trade date and contractual settlement date is greater than one business day. In addition, the proposed rule generally requires a broker-dealer to collect margin from a counterparty or take a capital charge within if the excess net mark to market loss has not been margined or eliminated by the close of business on the next business day after the business day on which such excess net mark to market loss arises. See paragraph (e)(2)(H)(ii)d.1. of Exhibit 4 to Amendment No. 1 (2021). Commenters have argued that these definitions and capital charge requirements presume a T+2 settlement date. This is not the case as the timeframes are solely used to determine which Covered Agency Transactions are in scope for purposes of the rule (under both the 2016 and 2021 Amendments) or when a broker-dealer must begin to take capital charges. They are not used to determine clearance or settlement dates or standards.

that are established and proven to function well. These commenters requested that the Commission reject the amendments in the proposed rule change and instead direct FINRA to revise FINRA-2015-036 to conform with long established market practices governing the clearance and settlement of Covered Agency Transactions (i.e., repeal the Covered Agency Transaction margin requirements).[324]

b. FINRA's Response to Comments

FINRA stated that Petitioners are using the proposed rule change as a vehicle to reopen the current rule under SR-FINRA-2015-036, an already concluded rulemaking process in which the Petitioners participated, including through the submission of numerous comment letters and participation in multiple meetings and telephone calls with Commission staff.[325] FINRA stated that Petitioners' overall issue is with the original rulemaking and the idea that FINRA can or should require broker-dealers to collect margin on Covered Agency Transactions.[326] FINRA further stated that Petitioners' efforts are, at best, untimely, and that Petitioners had an opportunity to request Commission and judicial review of SR-FINRA-2015-036 at the appropriate time and chose not to do so.[327] Further, FINRA stated that permitting a subsequent review of a previously approved proposed rule change such as SR-FINRA-2015-036 would invite serial litigation of SRO rulemaking processes, which would disincentivize SROs from proposing and implementing improvements to their existing rules through rule changes. Finally, FINRA stated it would create significant uncertainty for SRO members, their counterparties, and

---

324 See Mesirow Letter at 2; Weichert Letters at 2-3; Performance Trust Capital Letter at 2; Loop Capital Letter at 2; Siebert Letter at 2; Petitioners' Statement at 3-4; CastleOak Securities Letter at 2.

325 See FINRA Statement at 21.

326 See FINRA Statement at 12.

327 See FINRA Statement at 12.

other market participants, who would be uncertain as to what SRO rules are final and what approved rules could undergo further Commission review.[328]

c. Commission Discussion and Findings

The 2022 Scheduling Order granted the Petitioner's Petition for Review to review the Division staff's approval, pursuant to delegated authority, of FINRA's proposed rule change to amend the requirements for Covered Agency Transactions under FINRA Rule 4210, that is, the 2021 Amendments. The 2016 Amendments approved under the 2016 Approval Order are not before the Commission today and are outside the scope of this order.[329] If the Commission were to disapprove the proposed rule change, as modified by Amendment No. 1 (2021), the margin collection requirements under the current rule would be implemented under the implementation dates for SR-FINRA-2015-036 that are not a part of this proposed rule change.[330]

2. The Proposed Rule Change Does not Propose Additional Margin Requirements

a. Comments on the Proposal

Some commenters stated that FINRA and the Commission lack the authority to prescribe margin requirements for Covered Agency Transactions.[331]

b. FINRA's Response to Comments

FINRA stated that it addressed Petitioners' concern in the original rulemaking approved in the 2016 Approval Order, and the Covered Agency Transaction margin requirements are

328 See FINRA Statement at 12.

329 See File No. SR-FINRA-2015-036.

330 See Exchange Act Release No. 97062 (Mar. 7, 2023), 88 FR 15473 (Mar. 13, 2023) (File No. SR-FINRA-2023-002) (extending the implementation date of the margin collection requirements under SR-FINRA-2015-036 until October 25, 2023).

331 See Brean Capital Letter at 21-23; Melton Letter; BDA and Brean Capital Letter at 20-25; Boozman et al Letter at 2; Stephens Letter at 2; Petition for Review at 20-26; Petitioners' Statement at 3.

consistent with the provisions of Section 15A(b)(6) of the Exchange Act.[332] FINRA also stated that Section 7 of the Exchange Act sets forth the parameters of the margin setting authority of the Federal Reserve Board and does not bar action by FINRA.[333]

c. Commission Discussion and Findings

The current rule requires a FINRA member broker-dealer to collect margin from its counterparties with respect to Covered Agency Transactions. The 2016 Approval Order previously addressed the question of whether FINRA has the authority to prescribe margin requirements for FINRA member broker-dealers, stating that it is within FINRA's authority to impose margin requirements on its members.[334]

As discussed above, the proposed rule change contains narrow amendments to the current rule to reduce regulatory burdens on broker-dealers through the elimination of the two percent maintenance margin requirement for non-exempt accounts, and the addition of the option to take a capital charge in lieu of collecting the excess net mark to market loss, subject to specified terms and conditions. It does not propose any new margin collection requirements. Because the proposed rule change for the 2021 Amendments does not propose any new margin collection requirements, FINRA's authority to impose such requirements is not at issue with respect to the proposed rule change under review.

3. FINRA Previously Addressed Comments Related to the 2016 Amendments

a. Comments Received in Response to Proposal

---

332 See FINRA Letter at 7; FINRA Statement at 13-15.

333 See FINRA Letter at 7; FINRA Statement at 15-21.

334 See 2016 Approval Order, 81 FR at 40374 ("The stated goals of the proposal are consistent with the purposes of the Exchange Act and with FINRA's authority to impose margin requirements on its members.").

In addition to the comments above, the Commission received several comments on the proposal that were consistent with comments previously received regarding the current rule approved under the 2016 Approval Order. Commenters suggested that the counterparty exceptions in the rule be expanded to include U.S. Federal Home Loan Banks and mortgage originators.[335] Other commenters suggested that market participants should enhance central clearing through MBSD for Specified Pools and CMOs and exclude Specified Pools from the scope of the requirements of the rule.[336] Other commenters stated that FINRA should not require posting of margin until the next two SIFMA good day settlements.[337] In addition, several commenters stated that sales of new mortgage-backed securities do not settle on a T+2 basis, and suggested the trades at issue should be marginable only if they settle outside of the SIFMA good-day settlement schedule.[338]

b. FINRA's Responses to Comments

As discussed in section III.A.2.b. above, in response to the comments to the Notice, FINRA stated that it has engaged with industry participants extensively on their concerns, and has addressed them on multiple occasions since the process of soliciting comment on requirements for Covered Agency Transactions began in January 2014 with the publication of Regulatory Notice 14-02 and in 2015 with FINRA's original rulemaking for Covered Agency

335 See SIFMA Letter at 6; MBA Letter at 2-3.

336 See Brean Capital Letter at 23-25; Melton Letter.

337 See Brean Capital Letter at 25. Generally, a TBA trade is a transaction where the securities to be delivered are agreed upon on the trade date and are delivered in the future according to a monthly settlement schedule established by SIFMA, through consultation with its members. These settlement dates are generally referred to as "good day" settlement dates.

338 See BDA Letter at 2; Weichert Letters at 2; Stephens Letter at 3-4; Duncan-Williams/SouthState Bank Letter at 2, 4; BDA Small Firms Letter at 2, 3.

Transactions.[339] FINRA also stated that the original rulemaking is necessary because of the risks posed by unsecured credit exposures in the Covered Agency Transactions market.[340]

FINRA also stated that it has addressed, on multiple occasions, the need to include Specified Pool Transactions and CMOs within the scope of the requirements,[341] and made key revisions in finalizing the original rulemaking expressly to mitigate any potential impact on smaller firms and on activity in the Covered Agency Transaction market, including increasing the small cash counterparty exception from $2.5 million to $10 million, subject to specified conditions, and modifying the two percent maintenance margin requirement, as adopted pursuant to the original rulemaking, to create an exception for cash investors that otherwise would have been subject to the requirement.[342]

FINRA also stated that it exempted mortgage bankers from the maintenance margin requirements in the original rulemaking; exempted multifamily housing securities and project loan program securities from the new margin requirements;[343] and established a $250,000 de minimis transfer amount, for a single counterparty, subject to specified conditions, up to which members need not collect margin or take a charge to their net capital.[344] Finally, FINRA responded that it does not propose to make the suggested modification to exclude the U.S. Federal Home Loan Banks from the scope of the rule because it would undermine the rule's purpose of reducing risk.[345]

---

339 See Amendment No. 1 (2021) at 4.

340 See Amendment No. 1 (2021) at 4-5; 2015 Notice, 80 FR at 63615-16.

341 See Amendment No. 1 (2021) at 5; 2016 Approval Order, 81 FR at 40371.

342 See Amendment No. 1 (2021) at 5; 2015 Notice, 80 FR at 63608.

343 See Amendment No. 1 (2021) at 6; Partial Amendment No. 1 to SR-FINRA-2015-036, available at https://www.finra.org/rules-guidance/rule-filings/sr-finra-2015-036.

344 See Amendment No. 1 (2021) at 17; 2016 Approval Order, 81 FR at 40368.

345 See Amendment No. 1 (2021) at 17.

c. Commission Discussion and Findings

The Commission agrees with FINRA that some comments have been previously addressed in the original rulemaking, including whether to: (1) exclude additional products or counterparties from the scope of the rule, such as Specified Pools and CMOs; or (2) adjust the requirement to collect margin based on SIFMA's good day settlements.[346] Nevertheless, while the Commission agrees that these comments have been addressed previously, to the extent that they relate to the proposed rule changes set forth in the 2021 Amendments, and not solely to the 2016 Amendments, by suggesting alternative approaches to the 2021 Amendments that should be considered, the Commission disagrees with commenters' recommendations. Specifically, the Commission believes that excluding additional products or counterparties would undermine the purpose of the rule to address the risk of unsecured credit from Covered Agency Transaction for broker-dealers and encourage the collection of margin. In addition, excluding additional products from the scope of the rule would result in a mismatch between FINRA margin requirements and TMPG best practices of exchanging variation margin for Covered Agency Transactions which may potentially distort trading in the Covered Agency Transaction market by incentivizing counterparties to trade in non-margined products.

Moreover, the option to take a capital charge in lieu of collecting margin for the excess net mark to market loss will provide broker-dealers with the flexibility to choose not to collect margin from specific counterparties or for specific transactions, while continuing to protect broker-dealers from the risk of unsecured credit exposures arising from Covered Agency Transactions. In addition, adjusting the time to collect margin or take capital charges related to

346 See, e.g., 2016 Approval Order, 81 FR at 40375-76 ("[E]xcluding additional products from the rule or modifying the settlement dates in the definition of Covered Agency Transactions potentially may "undermine the effectiveness of the proposal" if counterparties are permitted to maintain unsecured credit exposures on these positions.").

SIFMA good settlement dates or other longer time periods also would undermine the effectiveness of the rule because these suggested changes would have the effect of generally requiring no margin or minimal capital charges (that is, they would have the effect of essentially reverting back to current and inconsistent margin practices among FINRA broker-dealers).

Finally, proposals to expand clearing for Covered Agency Transactions through MBSD is outside the scope of this proposed rule change.

IV. Conclusion

For the foregoing reasons, the Commission finds that the proposed rule change, as modified by Amendment No. 1 (2021), is consistent with the Act and the rules and regulations thereunder applicable to a national securities association.

IT IS THEREFORE ORDERED, pursuant to Rule 431 of the Commission's Rules of Practice, that the earlier action taken by delegated authority, Exchange Act Release No. 94013 (Jan. 20, 2022), 87 FR 4076 (Jan. 26, 2022), is set aside and, pursuant to Section 19(b)(2) of the Act,[347] the proposed rule change (SR-FINRA-2021-010), as modified by Amendment No. 1 (2021), hereby is approved.

By the Commission.

J. Matthew DeLesDernier,

Deputy Secretary.

[347] 15 U.S.C. 78s(b)(2).