ROPES & GRAY

ALERT

Asset Management

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Amended FINRA Rule Will Require Margin for TBA Transactions

On June 15, 2016, the Securities and Exchange Commission (the "SEC") approved the Financial Industry Regulatory Authority, Inc.'s ("FINRA") proposed amendment to FINRA Rule 4210, which will require U.S. registered broker-dealers to receive a minimum amount of margin from their counterparties (including buy-side entities) with respect to "Covered Agency Transactions" (as defined below), including "to-be-announced" (TBA) transactions.[1]

Many market participants currently do not exchange margin for TBA transactions. Following the financial crisis, the Treasury Market Practices Group sponsored by the Federal Reserve Bank of New York issued a recommendation that market participants exchange collateral for TBA transactions to mitigate credit risk (the "TMPG Best Practices").[2] Amended FINRA Rule 4210 follows the TMPG Best Practices in many respects, but departs from those recommendations by requiring only that margin be posted by the counterparty to the U.S. registered broker-dealer, rather than the bilateral exchange of margin. The Approval Order indicates, however, that parties are free to negotiate bilateral margining in their documentation.[3]

Mechanics of Amended FINRA Rule 4210

Scope – Covered Agency Transactions

The new requirements apply to TBA transactions[4] and specified pool transactions[5] for which the difference between the trade date and contractual settlement date is greater than one business day, and U.S. agency collateralized mortgage obligations[6] for which the difference between the trade date and contractual settlement date is greater than three business days (collectively, "Covered Agency Transactions").

Risk Limits

Under amended FINRA Rule 4210, a U.S. registered broker-dealer must determine, in writing, a risk limit for each counterparty to Covered Agency Transactions. If the broker-dealer is trading with advisory clients of a registered investment adviser; however, the risk limit determination can be made at the adviser level. Compliance with the margin requirements, however, must occur on a client-by-client basis.

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[1] See Exchange Act Release No. 34-78081 (June 15, 2016), *available* here (the "Approval Order").
[2] See Treasury Market Practices Group, *Best Practices for Treasury, Agency Debt, and Agency Mortgage Backed Securities* (November 2012), *available* here and the related white paper, *Margining in Agency MBS Trading* (November 2012), *available* here. See also the March 27, 2013 update to the TMPG Best Practices *available* here.
[3] *See* Approval Order at 34. The Approval Order also mentions that FINRA has noted that it intends to revisit a requirement for bilateral margining once the SEC finalizes its rules establishing minimum margin requirements for uncleared security-based swaps.
[4] See FINRA Rule 6710(u).
[5] See FINRA Rule 6710(x).
[6] See FINRA Rule 6710(dd).

Required Margin

Mark-to-Market Margin. Subject to certain exceptions described below, amended FINRA Rule 4210 will require U.S. registered broker-dealers to collect daily mark-to-market margin from each of their counterparties with respect to Covered Agency Transactions. Netting across positions in an account is permitted. Margin need not be transferred if the aggregate amount of margin owed by a single counterparty is less than or equal to $250,000. This minimum transfer amount appears to be measured at the level of the legal entity, not account by account, which could create issues for investment advisers who enter into Covered Agency Transactions on behalf of separately managed accounts.

Maintenance (Initial) Margin. In addition, U.S. registered broker-dealers will be required to collect maintenance (initial) margin equal to 2% of the contract value of each net long or net short position (by CUSIP). No maintenance margin is required to be collected from "exempt accounts," which include, among others, registered investment companies, U.S. state and local governments, and ERISA plans. "Exempt accounts" also include any person that has a net worth of at least $45 million and financial assets of at least $40 million and is either an SEC public reporting company or makes available to the U.S. broker-dealer information regarding such person's ownership, business, operations and financial condition that the U.S. broker-dealer reasonably believes to be accurate and sufficient for the purposes of performing a risk analysis in respect of such person.[7]

Also, no maintenance margin is required (even for non-"exempt accounts") if (i) the original contractual settlement for the transaction is in the month of the trade date or the month succeeding the trade date; (ii) the counterparty regularly settles its Covered Agency Transactions on a delivery-versus-payment (DVP) basis or for cash; and (iii) the counterparty does not engage in dollar rolls, "round robin" trades or other financing techniques with the applicable broker-dealer in connection with Covered Agency Transactions.

Timing and Consequences of Late Margin Transfer

Both maintenance margin and mark-to-market margin must be posted by the close of business on the business day following the date on which the margin deficiency arises. If margin is not transferred by this time, the broker-dealer is required to deduct the amount of the margin deficiency from its net capital. If a margin deficiency is not satisfied within five business days from the date the deficiency arose, the broker-dealer is required to liquidate the positions promptly, unless FINRA has specifically granted the broker-dealer additional time. These requirements may make it difficult for buy-side entities to dispute margin calls.

Exceptions

Amended FINRA Rule 4210 includes the following exceptions from the margin requirements:

Registered Clearing Agencies

Covered Agency Transactions that are cleared through a registered clearing agency, and that are subject to the margin requirements of that clearing agency, are not subject to the margin requirements under amended FINRA Rule 4210.

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

Gross Open Positions under $10 Million

U.S. registered broker-dealers are not required to comply with the margin requirements with respect to Covered Agency Transactions with counterparties that have gross open positions in Covered Agency Transactions with such broker-dealer that are less than or equal to $10 million if:

- the original contractual settlement for all such transactions is in the same month as the trade date for such transactions or in the month succeeding the trade date; and
- the counterparty regularly settles its Covered Agency Transactions on a delivery-versus-payment (DVP) basis or for cash.

The gross open position exception will not apply to a counterparty that engages in dollar roll, "round robin" or other financing techniques with respect to its Covered Agency Transactions with the broker-dealer.

The gross open position exception appears to apply on a legal entity basis, not account by account, which could limit the utility of this exception for investment advisers who enter into Covered Agency Transactions on behalf of separately managed accounts.

Compliance Dates

U.S. registered broker-dealers will be required to comply with the new margin requirements beginning in December 2017. Risk limits must be established beginning in December 2016.

Interaction with Other Margin Rules

While Covered Agency Transactions are typically not swaps or security-based swaps under CFTC or SEC rules, respectively, uncertainty remains as to the status of Covered Agency Transactions, and bond forwards generally, under EU regulation, including the European Market Infrastructure Regulation ("EMIR"). It is therefore possible that Covered Agency Transactions entered into between a U.S. registered broker-dealer and an entity subject to the requirements in EMIR will be subject to both the margin requirements under FINRA Rule 4210 and the margin requirements for non-cleared OTC derivatives under EMIR.

Practical Considerations for Buy-Side Entities

To prepare for the implementation of amended FINRA Rule 4210, buy-side entities will need to negotiate Master Securities Forward Transaction Agreements ("MSFTAs") (or other margin documentation) with U.S. registered broker-dealer counterparties to Covered Agency Transactions. Additionally, registered investment companies will need to establish triparty control arrangements with their custodians and such broker-dealers with respect to margin to be posted by the investment companies. Finally, investment advisers who enter into TBA transactions on behalf of separately managed accounts may consider what additional information they may seek from their clients in connection with the amended rule, including whether such clients are exempt accounts.

Please contact your usual Ropes & Gray adviser with any questions.

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