Client Alert

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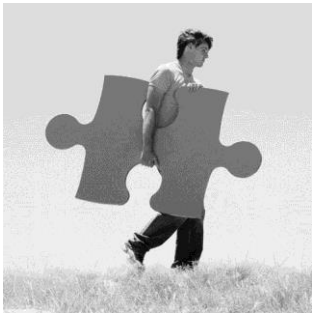

FINRA Delays Required Collateralization of TBAs and Other MBS Forwards

Late last month the Financial Industry Regulatory Authority, Inc. ("FINRA") filed with the Securities and Exchange Commission ("SEC") a proposed rule change to delay until June 2018 the implementation date of certain amendments to FINRA Rule 4210 ("Rule 4210"). When the amendments to Rule 4210 are implemented, they will require the collateralization of many forward transactions involving mortgage-backed securities ("MBS"). The proposed rule change, available here, effectively pushes back the date for compliance with Rule 4210's collateralization requirements from December 15, 2017 to June 25, 2018.[1]

Before FINRA's decision to delay the implementation of Rule 4210's margining requirements, the impending effectiveness of those requirements led market participants to rush to update their documentation for their MBS forward transactions. In its proposed rule change, FINRA stated that industry participants had requested additional time to amend their contractual documentation and to make required systems changes as necessary to come into compliance with amended Rule 4210. FINRA noted that it had received questions regarding the implementation of Rule 4210's collateralization requirements, had engaged in extensive discussions with industry participants and other regulators, and had made available a set of Frequently Asked Questions (available here) to facilitate market participants' compliance efforts.

When revised Rule 4210 goes into effect, it will require margining of "Covered Agency Transactions," a term that includes (i) "To Be Announced," or "TBA," transactions in certain securities where the parties agree that the seller will deliver to the buyer securities representing a pool or pools meeting certain criteria, but the specific securities to be delivered at settlement are not specified at the time of execution, for which the difference between the trade date and contractual settlement date is greater than one business day, (ii) "Specified Pool Transactions" in certain securities that are specified at the time of the execution, for which the difference between the trade date and contractual settlement date is greater than one business day and (iii) transactions in certain collateralized mortgage obligations for which the difference between the trade date and contractual settlement date is greater than three business days.[2]

Rule 4210, when its amendments are implemented, will require differing amounts of margin depending on the types of market participants that are parties to a transaction. For transactions between a FINRA member and an "exempt account" such as a registered broker-dealer, Rule 4210 in many cases will require the member to collect margin corresponding to changes in mark-to-market value (that is, variation margin). In contrast, in relation to transactions between a FINRA member and other, "non-exempt," accounts, Rule 4210 in many cases will require the member to collect both margin based on changes in mark-to-market value and "maintenance margin,"

[1] The proposed rule change states that the delay in implementing Rule 4210's margining provisions meets the requirements to become effective immediately and has become effective, subject to potential SEC review.
[2] Rule 4210(e)(2)(H)(i)(c). The version of Rule 4210 that is scheduled to go into effect on June 25, 2018, is available here.

generally defined as two percent of the contract value of the relevant net "long" or net "short" position.[3] As amended, Rule 4210 will in each case place the obligation to collect margin solely on the FINRA member, although it will contain no prohibition on "two-way," or reciprocal, margining for MBS forwards.

Most market participants have opted to update their documentation for MBS forwards by means of the Master Securities Forward Transaction Agreement published in December 2012 by the Securities Industry and Financial Markets Association (SIFMA). The Treasury Market Practices Group, an industry group sponsored by the Federal Reserve Bank of New York, helped to spur the move toward collateralizing such forward transactions starting in 2012, when it recommended margining such transactions to reduce counterparty and systemic risks.

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[3] Rules 4210(e)(2)(H)(ii)(d) and (e).