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FINRA RULE 4210

WILL YOU BE COMPLIANT?

Overview of the Regulatory Change

FINRA's amendment to [FINRA Rule 4210] will take effect on March 25, 2019. U.S. registered broker-dealers will need to start collecting margin requirements for Covered Agency Transactions.

Covered Agency Transactions include the following:

- To Be Announced (TBA) transactions, inclusive of adjustable rate mortgage (ARM) transactions, for which the difference between the trade date and contractual settlement date is greater than one business day;
- Specified Pool Transactions, for which the difference between the trade date and contractual settlement date is greater than one business day; and
- Transactions in Collateralized Mortgage Obligations (CMO's), for which the difference between the trade date and contractual settlement date is greater than three business days.

U.S registered broker-dealers will be required to:

- Determine and enforce a written risk limit for each counterparty to Covered Agency Transactions, performed on a client-by-client basis.
- Collect daily mark-to-market margins from their counterparties with respect to Covered Agency Transactions.
- Collect maintenance margin equal to two percent of the contract value for non-exempt accounts.

In the event of a margin deficiency, both mark-to-market and maintenance margins are to be posted by the end of the next business day. If the margin is not transferred within the specified timeframe, the broker-dealer is required to deduct the amount of the margin deficiency from its net capital. Broker-dealers must initiate liquidation proceedings, if after five business days, the margin deficiency is not satisfied. Exception being if a Regulatory Extension (REX) was granted by FINRA.

Exceptions to FINRA Rule 4210 will include the following:

- Covered Agency Transactions cleared through a registered clearing agency[1].
- Accounts/ firms with a net worth of at least $45 million and financial assets[2] of at least $40 million.
- Counterparties that have gross open positions in Covered Agency Transactions of 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 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.
- Arrangements between a member and a customer with respect to the customer's financing of proprietary positions in security futures, based on the member's good faith determination that the customer is an "Exempted Person," as defined in SEA Rule 401(a)(9), except for the proprietary account of a broker-dealer carried by a member

Challenges in Complying with the Regulation

FINRA's Rule 4210 amendment represents a substantial change for TBA's and other fixed-income transactions. Considering the

[1] A registered clearing agency refers to a clearing agency as defined in Section 3(a)(23) of the Exchange Act that is registered with the SEC pursuant to Section 17A(b)(2) of the Exchange Act.

[2] Financial assets refer to loans, leases, mortgages, or secured or unsecured receivables, and includes but is not limited to asset-backed securities.

complexity of the Rule requirements and the interdependencies of various functions related to the Rule, firms must leverage a coordinated strategy to meet the minimum standards of compliance. Gaining a thorough understanding of the challenges is an important aspect of this process.

1. Regulatory Challenges

The uncertainty, complexity, and lack of precedence – specifically with regards to exemptions –is a key challenge for firms required to comply with the new regulation. Firms will need to analyze the Rule, and be prepared to make adjustments. FINRA and the SEC have, to date, not provided any Rule interpretations to use as guidance for compliance with the Rule.

Firms must, at a minimum, establish a framework to support both the process of identifying and reviewing counterparties eligible for margining, and that of calculating and collecting the appropriate margin. It is important that firms maintain accurate data sources to effectively analyze, identify and collect margin on Covered Agency Transactions. The trick is implementing a cost-effective process that 1, is not labor-intensive; 2, allows for accurate margining calculations; and 3, is flexible enough to respond to business changes and new rule interpretations.

Determining a process for handling margin deficiencies is critical. Firms can request extensions in the REX system; the maximum number of days allowed per request is determined by the reason for the extension (i.e. mark to market disputes, non-US holidays, acts of God), and must be approved by FINRA. It is important to note, however, that as of yet, there is no industry standard for this process. Further, it is unclear whether the current rule for aged margin call extensions is only for an interim basis. This lack of guidance may create ambiguity, in terms of setting expectation for and negotiating legal terms around the liquidation of Covered Agency Transactions.

2. Operational Challenges

Firms, at least at first, are likely to hit the T+5 threshold and will need to institute processes around handling aged margin call extensions and liquidations – in addition to processes intended to circumvent such deficiencies.

It is recommended that firms conduct a gap analysis with the objective of identifying areas of concern and executing a strategic solution to align operational functions to the new requirements. This includes reviewing systems, in order to determine whether existing platforms can accommodate FINRA Rule 4210 margining activities. The final strategy should enable firms to perform margin calculations through a single, centralized process, defined in the firm's Policies and Procedures.

3. Financial Challenges

Process-wise, the finance team must be notified daily of any margin deficiencies and excess variation margin posted, to be included in the net capital charge calculations. The finance team must also establish their own process to monitor and report to FINRA, when the Rule's concentration thresholds are breached, and subsequently restrict TBA activity. Proper documentation must be maintained throughout, and to validate adherence to FINRA's due-diligence requirements.

There are also several challenges to consider, specifically concerning net capital and 15c3-3[3]

[3] According to FINRA, "Every broker or dealer must at all times have and maintain net capital no less than the greater of the highest minimum requirement applicable to its ratio requirement under paragraph (a)(1) of this section, or to any of its activities under paragraph (a)(2) of this section, and must otherwise not be

which include, monitoring for excess variation margin and incorporating it into the reserve formula or possession or control requirements (depending upon the type of margin collateral), and contemplating initial margin per the 15c3-3 requirements (again depending upon type of collateral).

Ensuring Compliance with the Rule

Implementing enterprise-wide change to adhere to the new margin requirements requires a significant investment in time and resources. However, there are solutions available to ease the burden and ensure the effectiveness of your firm's strategy around Rule 4210.

To prepare for the Margin Rule change, consider these initial steps:

- Invest in a technology solution to automate margin calculation & tracking, and integrate the platform into back-office functions and extant systems.
- Analyze existing protocol for compliance with the Rule, aside from margin requirements, and determine steps for documented revision & change adoption.
- Establish and monitor required "tentative net capital thresholds" over a 5-day rolling period.
- Identify, store and maintain specific account categories and transactions to be exempted from certain margin requirements.
- Incorporate margin calculations and contingencies into Master Securities Forward Transaction Agreements (MSFTAs), as needed.
- Begin testing and training personnel on FINRA's REX (Request for Extension) system to ensure readiness, in the case of a margin deficiency.

How Accordo Can Help

Accordo has formed a strategic partnership with Matrix Applications to provide our clients solutions for complying with Rule 4210. This includes tools for and guidance on automating margining, instituting strategic changes, and ensuring compliance with the regulation – all without significant disruption to the business. The partnership combines a technology component (Matrix Margin Calculator), with deep consulting expertise (Accordo) in regulatory change, change management, FINRA rule interpretation, and general risk, operations and compliance consulting.

Matrix's market-leading MarginCalculator is a simple, web-based solution for margining forward-settling trades, particularly TBAs, specified pools, ARMs and CMOs. It is the first 4210-specific tool to calculate exposure, due to market value fluctuations of unsettled positions, as well as margin collateral and cash, to mitigate such exposures; speed up and simplify reconciliation, alleviating stressful margin disputes; and maintain and monitor credit and risk policies, with sophisticated analytical tools and reporting.

Accordo is a diversified management consultancy, dedicated to delivering market-leading guidance to senior management at financial institutions. Accordo is well-prepared to advise on Rule 4210 requirements including:

- Reviewing and revising firms' Policies & Procedures to adapt to the complexity of the Rule;

"insolvent" as that term is defined in paragraph (c)(16) of this section."

- Conducting gap analyses on margining protocols, identifying and remediating issues, before they occur;
- Developing controls & conducting testing for ongoing maintenance;
- Validating models to ensure accuracy & efficiency of margin calculations; and
- Certifying adherence to margin requirements, as defined by Rule 4210.

With a fast approaching deadline, firms must act now to comply with the Rule, and stay ahead of this critical regulatory change.

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For more information on Accordo, please visit, accordo.solutions

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MATRIX APPLICATIONS

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