March 13, 2014

<u>In response to the request for comments in Regulatory Notice 14-02 regarding amendments to FINRA Rule 4210 and proposed TBA market margin requirements:</u>

In our opinion the proposed MBS transaction margin requirements as set forth in Notice 14-02 and in the proposed amendments to Rule 4210, while well intended, will have extremely negative consequences for markets, investors, consumers in search of home mortgages, and smaller broker dealers such as ourselves.

While understanding the intent of the amendments the risks they present to the MBS market, to market participants, and to the home buyer are far greater than the potential risks presented by book value degradation between trade and settlement dates on yet to settle trades. In over 20 years of experience stretching back to the early 1990s working for smaller brokerage businesses in which mortgage backed securities have been an integral part, the risks outlined as the reasons to subject such transactions to margin requirements have heretofore been little more than possibilities. Certainly history is not always the best guide, however despite tumultuous markets during this period of time the absence of margin requirements has had little if any deleterious effect on the function or integrity of the MBS market or our financial system as a whole. We believe the efficient functioning of the MBS market throughout these times of great financial upheaval does provide sufficient support to allow this segment of the financial marketplace to continue without the proposed added regulations.

These proposed changes are of great concern to us, potentially threatening the existence of the riskless principal model we follow, and possibly the survival of our firm and other similarly structured firms. However we do believe the impact on the system goes far beyond the potential demise of brokerage firms such as ours.

Large institutional investors will always have a large brokerage firm that will provide them with suitable access to the MBS market. However smaller institutional investors with sporadic investment activity are often not afforded the same access by larger brokerage firms, as their volume of business may be minimal. Smaller brokerage firms that will be most greatly affected by the proposed margin requirements are the firms that are motivated to provide smaller investors with access and information and expertise. With fewer smaller firms comes less access for the smaller investors, and fewer motivated market professionals to service them. The proposed rules amendments will effectively eliminate the ability of BDs with minimal net capital requirements to participate in the MBS market in any meaningful manner.

Even if smaller brokerage firms do survive, the proposed risk limitations may have a great impact on their ability to service clients. As risk limits are approached, brokerage firms will be regulatorily required to cut off access to markets. As market access is reduced or eliminated the number of potential market participants is reduced. The fewer available market participants the less liquid the securities. The less liquid the securities the more volatile the markets. If the need for covering margin requirements is triggered it is most likely because markets are struggling to start with. Without the margin requirement and risk limit restraints there is a better chance of stabilizing markets. Using history as a guide, no matter the condition of markets, trades settle anyway. Counterparties honor their commitments. Other than a single trade with Bear Stearns that we learned was never booked in the confusion of their last days, we have never been witness to a transaction in which a counterparty has backed away from an agreed upon trade.

From the perspective of the end investor it is reasonable to believe that given increased recordkeeping requirements along with the potential need for posting collateral prior to settlement fewer investors will have interest in buying mortgage backed securities. Looking at our client base, bankers may have an added incentive to shy away from investing in the MBS markets, quite possibly and understandably being disturbed at having to post collateral to buy securities they want to use as collateral. Not only will fewer MBS market participants potentially lead to a less liquid market but there may also be the unintended consequence of less money available for homebuyers looking for mortgages.

As referenced in the regulatory notice asking whether the rules changes will result in a shift of business to non-FINRA members we believe there is little doubt that the proposed rules changes will create an uneven playing field to the detriment of FINRA members. Why should a client choose to do business with a FINRA member with the associated real burdens of increased recordkeeping and the potential burdens of posting margin collateral when there are other easy to access providers who are not FINRA members and who are not burdened by FINRA rules in this regard? Putting ourselves in the shoes of our clients, most of whom are bankers and versed in weighing risk, we believe many would pay a premium for securities above the price we could secure for them in order to avoid exposure to extra regulatory requirement no matter how much they value our expertise

The riskless principal option itself may also be in peril. The riskless principal model is a valuable one, providing investors with a broker source that, rather than selling bonds from inventory, shops the market for the most appropriate investment option available unencumbered by positions the firm might hold. Low capital requirements are an incentive for firms to follow this model. The higher effective capital requirements of the proposed rules amendment may force riskless principals out of business, or limit what they can offer. Fewer firms following the riskless principal model means fewer options for end investors. We also believe that FINRA is a stronger and more effective organization with more rather than fewer members. A tiered system is already in place with those financial services organizations that are FINRA regulated and those that are not. Possibly a tiered system within FINRA that would exempt riskless principal model brokers from the MBS variation margin requirements and exposure limitations would be worthy of consideration if the rule changes cannot be set aside altogether.

From a firm perspective, despite maintaining capital that far exceeds our required level, there are very real impediments to our viability if these proposals become rule. In a volatile market both the 5% limit per client and the 25% overall limit could be reached easily. While it is understood that the intended purpose of limits is to avoid overwhelming exposure the idea that triggering these limits and reducing market access when clients may need that market access most acutely appears it would create more systemic risk rather than less.

The proposal to require the posting of variation margin based on mark-to-market calculations is also of great concern to us. Operating as a riskless principal we hold no other securities to use as collateral. Most likely if the de minimis level is reached with one of our brokerage counterparties the exposure would be spread out over a number of exempt clients who would not reach their de minimis threshold creating a funds imbalance until settlement day. It is understood that book profits will offset book losses in calculating exposure however much investment is done with cash and there is less potentially offsetting sell side activity. Additionally if markets are sliding rapidly bid to offer spreads often widen, magnifying the loss and reducing the profit side benefit.

To continue along the lines of bid to offer spreads and market value of securities, how will securities be valued? TBA pools are relatively easy to price in a universally accepted manner. CMOs and specified pools are considerably harder to value. This point is brought home to us every time we look to the street for bids for client securities. Certainly the closer to generic a pool gets the easier it is to value. However there are many characteristics that affect the value of a mortgage backed security. Among those characteristics are pool size, median loan size, geographic dispersion, and underlying credit. CMOs with their many different structures are even harder to value. How will these securities be valued? Yes market values are placed on bonds everyday however it is our experience that pricing services can be grossly inaccurate particularly in volatile markets. Even small price differences could mean the difference between having to post collateral or not.

Beyond the potential burden of meeting margin requirements, pricing unsettled bonds daily will require time, dollars and other resources. Recordkeeping requirements will most likely be more burdensome to smaller firms than larger ones. It may sound like prudent action to require the tracking of market values in this way. If there was little cost we would agree. However the burden could be substantial. Is it the proper and prudent way for the brokerage community to expend resources that could be better put to use serving the client? Particularly in an effort to address a potential risk that has not revealed itself in practice despite many market challenges.

To highlight our comments above we believe the proposed changes to the margin requirement rules will result in the following negative effects:

- reduced market access for clients
- reduced market liquidity
- reduced funds available for home mortgages
- shifts resources away from client service functions
- creates uneven playing field to the benefit of non-FINRA firms
- may push responsible firms out of the business
- may push firms to structures that do not fall under the auspices of FINRA

To end our commentary we would like to reference a portion of the Regulatory Notice that was drawn from the TMPG report. "Furthermore, the asymmetry that exists between participants that margin and those that do not could have a negative effect on liquidity, especially in times of market stress.[6]" If we are reading this correctly it is referencing the potential problems that may affect the mortgage backed market negatively if it is not subject to margin requirements as are other segments of the financial market. Looking at the great stress that the mortgage backed market has endured during the economic struggles of the recent past, we saw no greater negative impact to liquidity or efficient settlement nor undue dysfunction in the MBS market than any other financial market despite the absence of margin requirements.

Please look at the history and performance and mechanics of the MBS market and see the many negatives that the additional burdens as proposed in the amended Rule 4210 will present to a currently functional and efficient market.

Thank you for providing the opportunity to comment on this important rules change proposal.

Respectfully,

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