

RULE 4210 PRIMER

WHAT BUY SIDE FIRMS NEED TO KNOW TO COMPLY WITH FINRA'S MARGIN RULES FOR COVERED AGENCY TRANSACTIONS

10-STEP PRACTICAL GUIDE FOR COMPLIANCE IS INCLUDED

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TABLE OF CONTENTS

01	Summary
02	What is a Covered Agency Transaction?
03	Forward Settlement Risk in Covered Agency Transactions
04	Customers and Transactions that are Exempt from Rule 4210
05	Margin Calculation and Mechanics
06	Initial Margin or Additional Margin is Not Required
06	Master Securities Forward Transaction Agreement (MSFTA)
07	Practical Guide for Rule 4210 Compliance
08	References

SUMMARY

- EFFECTIVE DATE:

The covered agency transaction (**Covered Agency Transaction**) section of the Financial Industry Regulatory Authority's (FINRA's) Rule 4210 (**Rule 4210**) becomes effective on **May 22, 2024**.

- MARGIN REQUIREMENTS:

On the Effective Date, a FINRA-registered broker-dealer (**Member**) must begin collecting margin from a customer (**Customer**) (i.e., buy side) when it sells to the Customer a security that is the subject of a Covered Agency Transaction, including any such open transactions on the Effective Date.

- REGULATORY INTENT:

FINRA's intent for Rule 4210 is to reduce the Member's "forward settlement" risk that, between the Covered Agency Transaction's trade date (**Trade Date**) and contractual settlement date (**Settlement Date**), the Customer will be either unable or unwilling to pay for the securities.

- COVERED AGENCY TRANSACTIONS:

A Covered Agency Transaction is a "to be announced" (**TBA**) transaction, "specified pool" transaction (**Specified Pool**) or "collateralized mortgage obligation" (**CMO**).

- EXEMPTIONS:

Certain Customers and certain Covered Agency Transactions are exempt from the rule.

- CUSTOMER IMPACT:

Although Rule 4210 applies directly to Members and only indirectly to Customers, Customers should be aware that any failure to be prepared to post required margin by the Effective Date may lead to a disruption in their ability to continue trading Covered Agency Transactions.

➔ Customers are advised both to be familiar with, and follow, the most up-to-date version of Rule 4210 as announced by FINRA on August 18, 2023 (**August 2023 Rule Amendments**), which can be found [here](#).

10-STEP GUIDE FOR RULE 4210 COMPLIANCE Page 07

WHAT IS A COVERED AGENCY TRANSACTION?

A Covered Agency Transaction is an agreement to purchase a debt security with subsequent payment and subsequent delivery, which security carries a guarantee of timely payment of principal and interest from certain U.S. federal agencies or government-sponsored enterprises (**GSEs**). These agencies and GSEs include Fannie Mae, Freddie Mac, Ginnie Mae and the Small Business Administration. The guaranteed securities are backed by pools of loans and/or other assets and are issued to investors by a special purpose entity (**SPE**) through securitization. The unique features of these securities make them attractive to investors worldwide.

A Covered Agency Transaction can take the form of a:

- **To Be Announced (TBA)** transaction, in which the seller agrees to deliver a pool or pools of home mortgage or small business loans to the buyer at a specified face amount that meets certain criteria, inclusive of adjustable-rate mortgage transactions. The specific pool(s) to be delivered at the Settlement Date is not specified on the Trade Date, and the difference between the Trade Date and contractual Settlement Date is greater than one (1) business day;
- **Specified Pool Transaction (Specified Pool)**, in which the seller agrees to deliver a pool or pools of home mortgage or small business loans identified by a unique pool identification number to the buyer at the Settlement Date. Similar to TBA transactions, the difference between the Trade Date and contractual Settlement Date is greater than one (1) business day; or
- **Collateralized Mortgage Obligation (CMO)**, which is a securitized product backed by mortgage loans or other mortgage-related assets, structured into multiple classes or tranches and including a real estate mortgage investment conduit. Each class or tranche receives distributions of principal and/or interest according to specific requirements. In the case of a CMO, the difference between the Trade Date and contractual Settlement Date is greater than three (3) business days.

It is important to recognize that each type of Covered Agency Transaction involves a trade and settlement period that exceeds one (1) business day for TBA and Specified Pool transactions, and three (3) business days for CMOs. This time gap represents the different forward settlement risk associated with these transactions.



FORWARD SETTLEMENT RISK IN COVERED AGENCY TRANSACTIONS

The purpose of Rule 4210 is to reduce risk to Members in the event a Covered Agency Transaction fails to settle. This risk is most acute in the mortgage-backed security/securities (MBS) variety of TBAs, which also constitutes the overwhelming volume of trading in Covered Agency Transactions.

An MBS is a security that receives its principal and interest payments from a pool of underlying home loans, which are passed through to it by the SPE. The loans are underwritten by lenders across the U.S., and if the loans conform to certain guidelines set by an agency or GSE, they can be sold into a forthcoming MBS that is guaranteed by the agency or GSE.

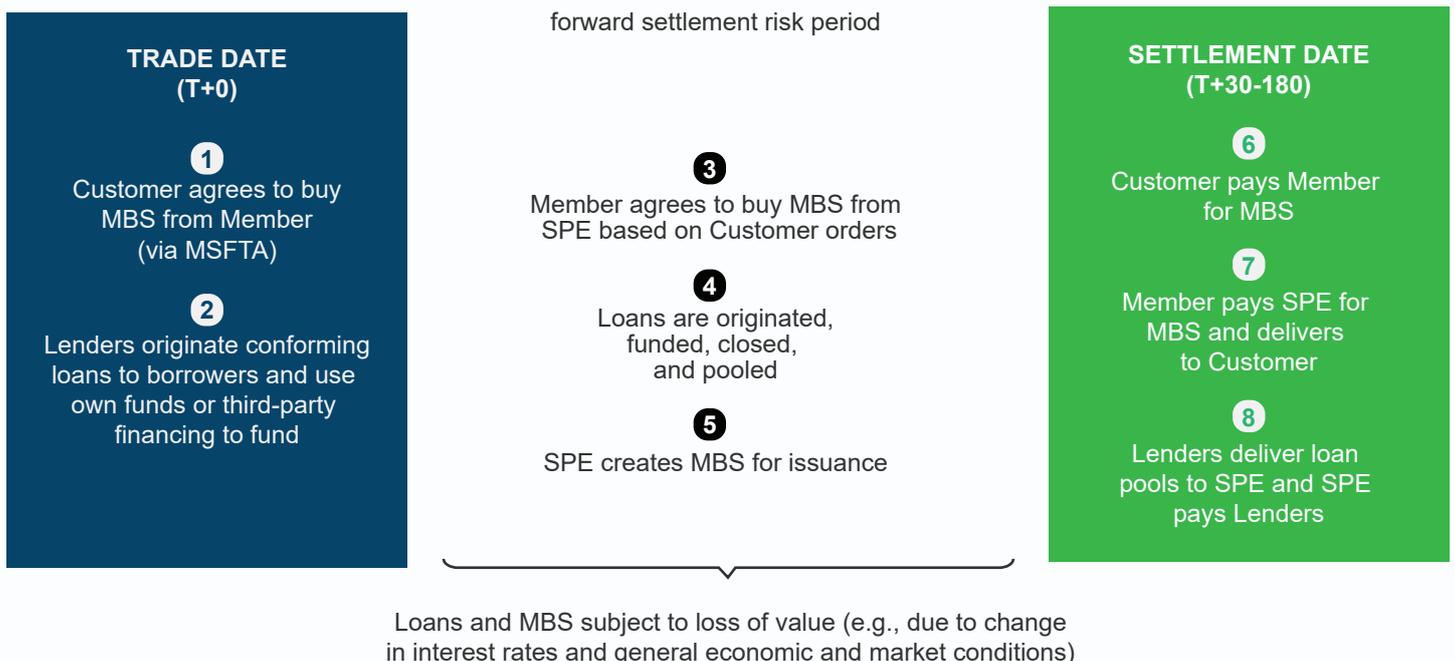
MBS transactions can take from 30 to 180 days to settle, though most settle towards the lower end of this range. The extended settlement period for an MBS transaction arises due to a timing characteristic in its creation. On the Trade Date (the date on which the Customer agrees to purchase the MBS from the Member), few, if any, of the credit and borrower details about the underlying pools are known¹. This is because many of the loans in the purported pool have yet to be identified or underwritten, a process that normally takes a few weeks to several months. Nevertheless, either because the Customer has agreed in advance to purchase MBS or, alternatively, there exists sustained market demand for them, lenders gain the confidence to offer rate locks, pre-fund loans (often relying on third-party financing) and work with borrowers to close the loans on or before the Settlement Date. On the Settlement Date, the Customer pays for the MBS, and lenders are reimbursed. During this same period, between the Trade Date and Settlement Date, the MBS itself is finalized by the SPE with the assistance of Members and other service providers for issuance to Customers as a tradable security. Crucially during this period, Members agree in writing (on penalty of financial, legal, and reputational risk) to purchase MBS from the SPE based on Trade Date subscriptions from their customers.

The market value of the underlying loan pools supporting the MBS, and consequently the MBS itself, can change between the Trade Date and Settlement Date. This change can be influenced by fluctuations in interest and currency exchange rates, general economic and market conditions, supply-demand imbalances in the housing market, and other factors.

Rule 4210 is intended to reduce Members' forward settlement risk by requiring Members to collect margin from Customers based on loss in market value of the MBS between the Trade Date and Settlement Date.

¹The above describes forward settlement risk and the securitization process for MBS TBAs. Similar processes are used for TBAs involving small business loans and for Covered Agency Transactions like Specified Pools and CMOs. However, in these cases, more, if not all, information about the underlying loans and assets is known at the Trade Date.

DIAGRAM OF FORWARD SETTLEMENT RISK IN MBS TBA



CUSTOMERS AND TRANSACTIONS THAT ARE EXEMPT FROM RULE 4210

Customers should be aware that Rule 4210 offers exemptions from specific margin requirements for certain customers (**Exempt Customers**) and certain transactions (**Exempt Transactions**). The chart below briefly describes each of these exemptions. If a Customer believes that one or more of these exemptions apply to its trading in Covered Agency Transactions, it should be prepared to present documentation supporting the exemption to Members upon request.

EXEMPT CUSTOMERS

EXPRESSLY EXEMPT CUSTOMERS	CUSTOMERS DESIGNATED AS NON-MARGIN COUNTERPARTIES
<p>Rule 4210 provides that a Member is not required to collect margin or take a capital charge in lieu of margin on Covered Agency Transactions if the Customer is a:</p> <ul style="list-style-type: none"> small cash counterparty (generally defined as a counterparty with open Covered Agency Transactions with the Member totaling \$10 million or less, subject to other criteria²), registered clearing agency, federal banking agency, central bank, multilateral central bank. foreign sovereign (except sovereign wealth funds), multilateral development bank, or the Bank of International Settlements. 	<p>A Member is also not required to collect margin from a Customer that is a non-margin counterparty (Non-Margin Counterparty).</p> <p>A Non-Margin Counterparty is a Customer that is not an Expressly Exempt Customer and meets one of the following criteria:</p> <ul style="list-style-type: none"> • The Member does not have the right, under a written agreement or otherwise, to collect margin on Covered Agency Transactions with the Customer, and to liquidate such transactions if the Customer has not satisfied the margin call within five (5) business days. • The Member does not regularly collect margin on Covered Agency Transactions with the Customer. <p>Customers should note that not all Members will choose to apply this exemption, and if a Member does, it will do so only after it carefully considers whether, in the event this exemption applies to a particular Customer, the result of such application to that Customer may have a deleterious effect on the Member's net capital requirements. This is because the Member must deduct the amount of margin it would otherwise collect from the Customer from the Member's computation of net capital. The deduction to net capital is subject to certain limitations, including the Member's written risk limitation for the Customer, and may not exceed \$25 million in the aggregate across all such accounts of its Customers.</p>

EXEMPT TRANSACTIONS

Under Rule 4210, a Member is not required to include, in the calculation of a Customer's margin requirement, any Covered Agency Transactions in multifamily housing securities or project loan program securities that are issued in conformity with the guidelines of a federal agency or GSE, provided that these securities are documented and commonly known to the market as:

Freddie Mac K Certificates,
 Fannie Mae Delegated Underwriting and Servicing Bonds,
 Ginnie Mae Construction Loan or Project Loan Certificates, or
 such other securities with similar characteristics as FINRA may designate by notice or similar communication.

² Per FINRA Rule 4210(e)(2)(H)(i)h, a counterparty is a "small cash counterparty" if:

1. 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;
2. 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;
3. the counterparty regularly settles its Covered Agency Transactions on a Delivery Versus Payment ("DVP") basis or for "cash"; and
4. 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, or use other financing techniques.

MARGIN CALCULATION AND MECHANICS

Unless a customer is an Exempt Customer or the Covered Agency Transaction is an Exempt Transaction, Rule 4210 requires a Member to collect margin on any open Covered Agency Transactions that exceeds a Customer's net mark to market loss, with a \$250,000 de minimis transfer exception (**Excess Net Mark to Market Loss**).

Excess Net Mark to Market Loss is not solely based on bilateral Covered Agency Transactions between the Member and the Customer. The Member can offset Customer losses against certain itemized gains in favor of the Customer. Please refer to the sample margin call statement below for a detailed view of the calculation.

Due to market convention and FINRA's requirement that Members deduct from the computation of their net capital: (i) any unmargined net mark to market loss below the \$250,000 de minimis transfer exception and (ii) any Excess Net Mark to Market Loss that has not been margined or eliminated by the close of business on the next business day after the business day such loss arises, Customers can expect Members to seek to collect margin daily. In certain circumstances, Members must liquidate outstanding Covered Agency Transactions if a Customer has not delivered margin within five (5) business days of the requirement arising.

Members typically send margin notices to Customers by 10:00 a.m. New York time and expect to receive margin from Customers by the close of business the same day. If the notice is received after 10:00 a.m. New York time, the margin is due by the close of business on the next business day. Cash or U.S. Treasuries and other marginable securities subject to reasonable risk-sensitive haircuts are typical margin collateral. Customers should also be prepared to call the Member daily for the return of any collateral posted greater than the Excess Net Mark to Market Loss.

EXCESS NET MARK TO MARKET LOSS CALCULATION Sample Margin Call Statement

RULE 4210 MARGIN CALCULATION (ALL VALUES FROM PERSPECTIVE OF CUSTOMER)

CUSTOMER LOSSES

- Mark to market losses on Covered Agency Transactions (CATs)
- Member guarantees on CATs to third parties on behalf of Customer

CUSTOMER GAINS

CATs:

- Mark to market gains on CATs
- CAT guarantees to Customer by Member
- CATs cleared by Member for Customer
- CATs in which Member has a first-priority perfected security interest

In the Money OTC Put Options on CATs:

- Customer's long puts written by Member
- Customer's long puts guaranteed by Member
- Customer's long puts cleared by Member
- Customer's long puts in which Member has a first-priority perfected security interest

equals

NET MARK TO MARKET LOSS

minus

DE MINIMIS TRANSFER EXCEPTION

\$250,000

equals

EXCESS NET MARK TO MARKET LOSS

minus

CASH AND MARGIN SECURITIES POSTED TO MEMBER (SUBJECT TO HAIRCUT / MAINTENANCE)

equals

MARGIN DUE FROM (RETURN TO) CUSTOMER

INITIAL MARGIN OR ADDITIONAL MARGIN IS NOT REQUIRED

Rule 4210 expressly states that Members are not required to collect margin or take a capital charge on Covered Agency Transactions, except for an amount related to Excess Net Mark to Market Loss. A significant feature of the August 2023 Rule Amendments is the removal of Members' obligation, as stipulated in prior iterations of the rule, to collect so-called "initial margin" or "additional margin" on these transactions. Customers should note that certain margin securities posted as collateral in their accounts for Covered Agency Transactions may attract maintenance margin requirements.

MASTER SECURITIES FORWARD TRANSACTION AGREEMENT (MSFTA)

Rule 4210 does not mandate, nor does FINRA endorse, any specific documentation type for parties involved in a Covered Agency Transaction. However, to offset a Customer's losses against its gains for margin calculation or to unilaterally early terminate and liquidate for failure to post required margin, a Member must have a legally enforceable right.

Market participants have traditionally utilized the Master Securities Forward Transaction Agreement (**MSFTA**) published by the Securities Industry and Financial Markets Association (**SIFMA**) for buying and selling various securities with a delayed delivery, i.e., forward settlement date. The MSFTA is a bilateral master netting agreement that enables parties to establish a single agreement at the relationship level. Individual transactions are then documented separately as needed in trade confirmations.

The current version of the MSFTA is the 2012 publication (**2012 MSFTA**), comprising a 13-page pre-printed form and annexes for customization. In response to Rule 4210, SIFMA released an amendment to the 2012 MSFTA, which latest version is known as the **2022 MSFTA Amendment**, recently updated for the August 2023 Rule Amendments.

Customers should be aware that the August 2023 Rule Amendments reflected in the 2022 MSFTA Amendment generally offer more favorable terms for Covered Agency Transactions. For instance, existing MSFTAs requiring "initial", "maintenance" or "additional" margin for these transactions or that make distinctions between "exempt" and "non-exempt" accounts, are obsolete under the August 2023 Rule Amendments. Therefore, it is recommended that customers review their existing MSFTAs and update them accordingly.

When negotiating an MSFTA with a Member, Customers should exercise caution regarding attempts to expand the enumerated events of defaults or agree to changes impacting credit risk, such as those involving import or export of defaults across products, agreements, or affiliates. These and other modifications can lead to operational, economic and legal distress, particularly during periods of market turbulence.



PRACTICAL GUIDE FOR RULE 4210 COMPLIANCE

Covered Agency Transactions are not new products or revenue streams. However, before, on, and after the Effective Date, Customers will incur additional costs and may need to implement new processes to continue trading Covered Agency Transactions. Money managers and similar firms that act on behalf of multiple customers will need to scale accordingly.

Outlined below are practical steps Customers can take to achieve Rule 4210 compliance by the Effective Date. Although the steps are numbered, some may need to be carried out concurrently, and additional steps may be necessary. Customers should carefully consider their own business and operational requirements when planning for Rule 4210 compliance.

10 PRACTICAL STEPS TOWARDS RULE 4210 COMPLIANCE

STEP

ACTION

- 01** Determine if the Customer and/or underlying account(s) is an Exempt Customer and be prepared to provide Members with evidence of such exemption, and certify this status in MSFTAs.
- 02** Determine if the Customer and/or underlying account(s) seeks to execute only Exempt Transactions. If so, the Customer will need to certify this in MSFTAs.
- 03** Identify and prioritize accounts that trade, or may need to trade, in Covered Agency Transactions, considering volume needs. Be prepared to provide Members with know-your-customer, anti-money laundering, and credit risk diligence related information and documentation, if requested.
- 04** Assess at the operational level whether technological or other enhancements to meeting margin requirements are necessary for Rule 4210 readiness. Work to implement these enhancements by the Effective Date.
- 05** Identify and prioritize Members with whom the Customer intends to trade Covered Agency Transactions. Review and respond to any Customer- or account-level policies mandating enhanced risk assessment when posting margin, or those that limit exposure to, or restrict Members to whom margin may be posted.
- 06** Draft and prepare any required MSFTA templates and Rule 4210 amendments, and proactively distribute them to Members.
- 07** Negotiate and execute MSFTAs and Rule 4210 amendments with Members. For registered investment companies, ensure to amend or put in place control agreements with fund custodians and Members that are mapped to the MSFTA.
- 08** Update internal processes, procedures guides and checklists for trading desks, risk department, legal, documentation teams and operations.
- 09** Test operational readiness for Rule 4210 margin requirement capability by selecting one or two Members to run a simulated trade exercise.
- 10** May 22, 2024: begin trading Rule 4210 compliant Covered Agency Transactions.

REFERENCES

Regulatory Notice 23-14, *Amendments to Covered Agency Transaction Requirements under FINRA Rule 4210; Announcement of Effective Date*, Financial Industry Regulatory Authority (FINRA) (Aug. 18, 2023).

FINRA Manual: Rule 4210, available at <https://www.finra.org/rules-guidance/rulebooks/finra-rules/4210> (last visited Jan. 2, 2024).

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Andreas Fuster, David Lucca and James Vickery, *Mortgage-Backed Securities*, Staff Reports, No. 1001, Federal Reserve Bank of New York (Feb. 2022), available at https://www.newyorkfed.org/research/staff_reports/sr1001.html (last viewed January 2, 2024).

Treasury Market Practices Group, *Best Practices for Treasury, Agency Debt, and Agency Mortgage-Backed Securities Markets*, Federal Reserve Bank of New York (July 2019), available at https://www.newyorkfed.org/tmpg/best_practices.html (last visited Jan 2., 2024).

Uniform Practices for the Clearance and Settlement of Mortgage-Backed Securities and Other Related Securities, Securities Industry and Financial Markets Association, available at <https://www.sifma.org/resources/general/tba-market-governance/> (last visited Jan. 2, 2024).

Form of Amendment to Master Securities Forward Transaction Agreement to Conform with FINRA 4210, Securities Industry and Financial Markets Association, available at <https://www.sifma.org/resources/general/mra-gmra-msla-and-msftas/> (last visited Jan. 2, 2024).

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For more information on Rule 4210 and for advice and assistance regarding compliance with Covered Agency Transactions, or for help achieving any of your financial transaction goals, please contact Mr. Gillespie using the details below.

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