FINRA Rule 4210 Compliance Readiness and MSFTA Negotiation for U.S. Public Pension Plans

Benjamin Lee, CFA
GuyLaine Charles

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INTRODUCTION

This article discusses the Financial Industry Regulatory Authority ("**FINRA**") amendments to Rule 4210 which imposes margin requirements on forward transactions in certain fixed income markets. The margin requirements are scheduled to become effective March 25, 2020, and will affect U.S. public pension plans ("**Pension Plans**") that transact in these markets. We further discuss the use of the Master Securities Forward Transaction Agreement ("**MSFTA**") by market participants to comply with the new regulations, including MSFTA contract negotiation issues common to many Pension Plans. Lastly, we share the experience of the New York State Teachers' Retirement System ("**NYSTRS**") in negotiating MSFTAs with various broker-dealers ("**dealers**") for its fixed income portfolios.

BACKGROUND

Most Pension Plans have significant allocations to fixed income securities. NYSTRS, for instance, has a target allocation to domestic fixed income of 16%, with a range of 12-20%. Other than the treasury market, one of the largest and most liquid fixed income markets is the trading of agency mortgage-backed securities ("**MBS**") taking place in the forward-settling, to-be-announced ("**TBA**") market.

The steps for a TBA trade are as follows: (i) on the trade date, the parties enter into the trade based on certain agreed-upon parameters rather than the specific identity of the MBS; (ii) on the notification date, which occurs two business days prior to the settlement date, the seller notifies the buyer of the details of the MBS that will be delivered; and (iii) on the settlement date, the parties settle the transaction on a delivery-versus-payment basis. In the TBA market, the settlement date can be scheduled days,

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weeks or months into the future, with most trades settling approximately one month forward.

Forward-settling transactions can increase the risk that a counterparty may not be able to fulfill its obligations ("**counterparty credit risk**") owing to market value changes of the underlying security between the trade date and the settlement date. One way to mitigate counterparty credit risk is to periodically mark-to-market unsettled positions and have the party with the net forward exposure (either the buyer or the seller) post variation margin to the other party.

■ FINRA RULE 4210 MARGIN REQUIREMENTS

On November 14, 2012, the Treasury Market Practices Group ("**TMPG**"), which promotes best practices in the treasury, agency debt and agency MBS markets, recommended that forward-settling transactions, including agency MBS transactions, be margined to mitigate counterparty credit risk and systemic risk posed by unmargined transactions. The TMPG, sponsored by the Federal Reserve Bank of New York, is an industry group which includes securities dealers, banks, buy-side firms and others. To facilitate the implementation of the TMPG's recommendation, also on November 14, 2012, the Securities Industry and Financial Markets Association ("**SIFMA**") announced a new version of its MSFTA, a standard form agreement that enables the trading of forwards on certain securities. The new version of the MSFTA, dated December 2012, provides for bilateral margining in the body of the document, and dispenses with separate margining annexes.

Despite the TMPG recommendations and the new MSFTA, in the absence of regulations requiring margining for forward-settling transactions, voluntary margining had not seen widespread adoption in the industry between dealers and their counterparties.

To ensure compliance, in June 2016, the U.S. Securities Exchange Commission approved FINRA's amendments to Rule 4210, which impose, among other things, margining requirements for forward-settling "covered agency transactions" (including TBAs, specified pools and CMOs) entered into by market participants, including Pension

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Plans. Unlike the TMPG recommendations, the margin requirements under FINRA 4210 are not bilateral as the dealer is required to collect margin from the counterparty (as discussed below), but not required to post margin. Originally scheduled to become effective on December 15, 2017, after several postponements, the margin requirements are now scheduled to become effective on March 25, 2020.

Under FINRA Rule 4210 as amended, the dealer is required to calculate variation margin on a daily basis and collect collateral from its counterparty based on the net forward exposure of unsettled positions, subject to a minimum transfer amount of no greater than $250,000. Furthermore, a minimum maintenance margin (the equivalent of initial margin) in the amount of 2% of the net "long" or "short" position by CUSIP must be requested by dealers when facing certain counterparties.

Section4210(a)(4)(F) of the FINRA Rule, as amended, provides that "a pension or profit sharing plan subject to the Employee Retirement Income Security Act (ERISA) or of an agency of the United States or of a state or a political subdivision thereof" is considered a "designated account." "Designated accounts," are in turn "exempt accounts." An "exempt account" is exempt from maintenance margin requirements, but still subject to variation margin requirements. In negotiations, NYSTRS has made the "designated account" representation in the MSFTA or an amendment thereto. In the absence of such self-identification, Pension Plans may be subject to maintenance margin requirements. Pension Plans that provide such representation should attempt to obtain an acknowledgement from each dealer of the plan's status and exemption from maintenance margin.

Margining is not only an operational matter but also a contractual matter. The MSFTA has seen increasingly widespread adoption, and has emerged, together with the SIFMA-published amendment to the MSFTA to conform with FINRA 4210, as the primary contractual means to comply with the new margin requirements.

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■ MSFTA NEGOTIATION

Despite the fact that the MSFTA is a standardized industry-accepted agreement, its terms are often heavily negotiated. Like the International Swaps and Derivatives Association, Inc. ("**ISDA**") Master Agreement, the MSFTA follows a general architecture in which any amendment to the pre-printed form agreement must be made in a separate document — the Schedule in the case of the ISDA Master Agreement and the Annexes in the case of the MSFTA. The MSFTA pre-printed form is 13 pages, and modifications are primarily made through Annex I. Annex II includes the parties' notice information and Annex III provides additional representations, obligations and limitation of liability for a party acting as agent for one or more principals.

For internally managed portfolios, Pension Plans can enter into direct bilateral MSFTAs with dealers. For externally managed separate accounts, MSFTAs are often structured as "umbrella" MSFTAs. In an umbrella MSFTA, an external manager negotiates a single MSFTA with a particular dealer on behalf of all of the manager's clients. Each client (such as NYSTRS) is then added, via an amendment, to the umbrella MSFTA to enable the manager to engage in relevant trades with that dealer for that specific client's account. Thus, the typical umbrella MSFTA includes, first, the pre-printed form; second, the Annexes reflecting terms agreed to between the manager and the dealer that apply to all clients; and third, a client-specific amendment containing changes that apply only to that specific client.

All dealers customize their MSFTAs, as do external asset managers. Whether entering into an umbrella MSFTA or a direct MSFTA, a Pension Plan should carefully evaluate, and if necessary, amend each MSFTA in light of the plan's particular circumstances and its unique operational and legal policy requirements and preferences. NYSTRS reviews and negotiates all of its MSFTAs without exception. For its externally managed accounts, NYSTRS generally does not give its external managers permission to enter into an umbrella MSFTA unless NYSTRS has reviewed and approved such MSFTA. NYSTRS requires that NYSTRS-specific provisions and changes be

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incorporated contemporaneously with NYSTRS becoming a party to the umbrella agreement.

Each Pension Plan can, to some extent, structure its MSFTAs to suit its unique needs. There is often no clear line between "business" and "legal" issues, and therefore inhouse counsel should be familiar with all issues in an MSFTA.

Business-related terms to consider include, among others:

- types of eligible forward collateral and applicable haircut amounts;
- bilateral margining;
- minimum transfer amount (up to $250,000) and threshold amount, if any, with respect to the dealer;
- valuation methodology and pricing services used (if this is amended by the dealer);
- calculation of forward exposures;
- treatment of negative interest rates on posted collateral; and
- cut-off times for same day margining.

Inhouse counsel should be familiar with all these business concepts and should consult with their internal investment team to determine the preferences on such terms.

Mixed business-and-legal terms include, among others:

- dispute resolution processes for valuation of net forward exposure or of posted collateral;
- events of default and their cure periods;
- deemed waiver of an event of default;
- automatic early termination upon the insolvency of a party;
- cross-default;
- remedies upon an event of default;
- set-off and limited recourse provisions;
- limitation of liability and payment of damages;
- general representations; and

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- delivery of financial and other information.

These mixed provisions are often jointly reviewed by legal and business staff. For example, even something as mundane as cure periods may need to be discussed internally as many dealers do not provide for a cure period for events of default. As a result, a technical or operational error by a Pension Plan could expose the plan to the risk of a close-out of all transactions by the dealer.

Legal issues include, among others:

- ERISA representations;
- governing law;
- submission to jurisdiction;
- service of process;
- sovereign immunity; and
- jury trial.

Typically, business staff defers to legal staff on these legal issues. Of note, the standard form of MSFTA contains both a waiver of sovereign immunity and a waiver of the right to a jury trial, one or both of which waivers are problematic for many Pension Plans and will have to be specifically negotiated out of the MSFTA. Additionally, the standard MSFTA applies New York governing law and irrevocably submits the parties to the exclusive jurisdiction of courts sitting in the State of New York.

Most, if not all, dealers and external managers already have their preferred terms pre-loaded into their MSFTAs by the time the documentation is first presented to Pension Plans for review and execution. The Annex I provided by a dealer or manager may deviate significantly from the model SIFMA form. Accordingly, any Pension Plan that signs a direct dealer MSFTA or a manager umbrella MSFTA without reviewing or negotiating it may unwittingly agree to provisions that are contrary to the plan's internal policies and preferences.

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■ NYSTRS' EXPERIENCE

NYSTRS began its MSFTA documentation process in the middle of 2017, due to the then-impending 12/15/17 compliance deadline. As a first step, NYSTRS' Legal Department and Fixed Income Department, with the assistance of outside legal counsel, jointly reviewed the standard MSFTA and determined NYSTRS' required or preferred terms on every provision. This exercise resulted in an internal master checklist of MSFTA issues and preferred terms, which then formed the general basis for reviewing and negotiating all MSFTAs in a highly structured, organized and consistent manner. Most dealers have been accommodating of NYSTRS' requested provisions. In total, NYSTRS started negotiations on eighteen MSFTAs, of which sixteen were ultimately executed. The remaining two were not pursued further, as sufficient trading liquidity had been attained.

The postponements of the effective date of the new FINRA Rule 4210 margin requirements (first 12/15/17, then 6/25/18, then 3/25/19, and 3/25/20 as of this writing) have been a double-edged sword for NYSTRS. Impending compliance dates provided much needed motivation and momentum for the dealers to complete their negotiations with NYSTRS, but presented the risk of NYSTRS being unable to execute all of its MSFTAs by the compliance date. On the other hand, postponements gave the parties more time to negotiate, but often resulted in dealer delays and decreased responsiveness to NYSTRS' comments on its MSFTAs.

Having an efficient, well-organized legal process is key to managing the documentation process when dealing with a high volume of MSFTAs. Consider, for example, a hypothetical Pension Plan that has two external managers (A and B), where manager A has umbrella MSFTAs with dealers 1, 2 and 3; and manager B has umbrella MSFTAs with dealers 1, 4 and 5. In addition, the Pension Plan wishes to have direct MSFTAs with dealers 1, 3 and 6 for its internally managed portfolios. In this case, the Pension Plan may need to review and negotiate a total of nine MSFTAs with six dealers. Each manager's umbrella MSFTAs will be different, even if they are with the same dealer. In a situation like this, which is not uncommon, it is paramount for inhouse or external

counsel to track all MSFTAs simultaneously in order to take consistent negotiating positions and obtain consistent results, particularly when negotiating multiple MSFTAs with the same dealer.

Most of NYSTRS' MSFTAs were executed by mid-2018, with a few remaining ones executed in early 2019. As of this writing, NYSTRS has completed its MSFTA documentation project. NYSTRS' sixteen MSFTAs include direct MSFTAs (for internal portfolios) and umbrella MSFTAs (for externally managed accounts), with multiple different dealers, all of which contain NYSTRS' required or preferred terms. In addition, in most of its direct MSFTAs, NYSTRS has negotiated that the parties are not required to post variation margin until the FINRA Rule 4210 compliance date. With a full set of MSFTAs in place and ample time to gear up operationally, NYSTRS is in position to comply with the new FINRA Rule 4210 margin requirements well ahead of the scheduled March 25, 2020 implementation date.

ABOUT THE AUTHORS

Benjamin Lee, CFA, is Senior Managing Counsel for Investments at New York State Teachers' Retirement System and can be reached at benjamin.lee@nystrs.org. GuyLaine Charles is the founder of Charles Law PLLC and can be reached at guylaine@charleslawpllc.com.

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