Overview

Forward Settling Securities Transactions and the Master Securities Forward Transaction Agreement ("MSFTA")

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Forward-settling MBS trades allow mortgage originators to hedge interest-rate and market risk on open mortgage commitments while providing investors with a liquid and in many cases low credit-risk investment with superior yields over Treasuries.

As with all forward-settling transactions, the parties become contractually bound to sell and buy the MBS on the date they agree to the forward transaction (“trade date”), but do not settle the trade until a date (“settlement date”) later than the ordinary spot delivery date. Normally there will be a change in the value of the transaction between the trade date and the settlement date, creating a risk that a party may not be able to or may not wish to fulfill its obligations on the settlement date.

The average time between the trade date and settlement date is between 25 days and 3 months. Over 95% of the volume of MBS forwards is in “to be announced” MBS forwards (“TBA's”) where the MBS to be delivered is not specified on trade date and where the seller may deliver any MBS meeting industry standards on the settlement date.

Counterparty Credit Risk/Systemic Risk

To address the risk of non-performance at settlement, referred to as “counterparty credit risk” as well as “systemic risk” (the domino effect on the market that could ensue if the defaulting party is systemically important), the Treasury Market Practices Group (the “TMPG”), an advisory committee to the Federal Reserve Bank of New York, recommended that forward settling MBS transactions, including TBAs, be subject to documentation and bilateral variation margining after 2013. These guidelines, which were adopted by most large MBS dealers, required a heavy lift both from an operational and documentation standpoint.

To comply with the new TMPG guidelines, parties were required to either obtain new collateral management systems or upgrade existing systems. These systems would have to be able to value transactions, determine the collateral requirements, value collateral, apply the requisite “haircuts” (markdowns in value) and reconcile portfolios. In addition, from a legal perspective, parties were required to enter into an agreement providing for bilateral margining if they did not have one already.

While the larger participants in the market endeavored to meet these deadlines, because the TMPG guidelines were recommendations and not mandatory, compliance was inconsistent.

To address systemic risk and ensure compliance with margining of most forward-settling MBS transactions, on October 6, 2015, the Financial Industry Regulatory Authority (“FINRA”) filed with the Securities and Exchange Commission (the “SEC”) a proposed change to its margin rule.

FINRA, which is an independent not-for-profit organization authorized by Congress to protect investors, proposed to amend the existing FINRA Rule 4210, governing margin requirements that must be applied by FINRA members, to require the posting of margin with respect to almost all MBS forward transactions. On June 15, 2016, the SEC approved the amendment and Rule 4210 was scheduled to become effective on December 15, 2017, except for requirements for dealers to make “risk limit determinations” for all their customers, which became effective on December 15, 2016.

The effective date of December 15, 2017 for the remaining requirements has since been postponed multiple times and is currently scheduled for October 26, 2021, providing FINRA with additional time to consider, in consultation with industry participants and other regulators, whether any revisions to the amendments to Rule 4210 would be appropriate to promote stability and avoid unnecessary disruption in the market.

Rule 4210, if it goes into effect in its current form (“Adopted Rule 4210”), would subject registered broker-dealers (“Dealers”) and, indirectly, their customers to specific margining requirements with respect to the following forward transactions:

1. TBA transactions, including adjustable rate mortgage transactions;

2. specified pool transactions in agency MBS; and

3. collateralized mortgage obligations (“CMO's”), issued in conformity with a program of an agency or a government-sponsored enterprise.

An MBS transaction listed in 1 or 2 above is considered to be a forward covered by Adopted Rule 4210 if it does not settle within one business day after trade date and a CMO transaction is covered if it does not settle within three business days of trade (collectively, “Covered Agency Transactions”).

Adopted Rule 4210 applies only to transactions with Dealers that are members of FINRA. Other Dealers, such as banks, are not required to apply Adopted Rule 4210, although the TMPG guidelines may cause them to adopt bilateral variation margining requirements.

Adopted Rule 4210 requires that, with respect to Covered Agency Transactions, Dealers must:

1. establish in writing risk limits with respect to each of their counterparties and enforce such risk limits (the “risk limit determination”);

2. require almost all counterparties to post collateral to cover the Dealer's Net Unsecured Forward Exposure (the mark-to-market) for all Covered Transactions (in other words, to post variation margin); and

3. in addition, require certain smaller counterparties to post “maintenance margin” in the amount of 2% of the net “long” or “short” position by CUSIP of Covered Transactions (or to maintain that amount of equity in an account with the Dealer), unless those smaller counterparties can avail themselves of another exemption under Adopted Rule 4210 as specified under “Transaction Type Exemptions” in Exhibit A. Counterparties subject to the maintenance margin requirements are entities that are not Exempt Accounts or otherwise subject to an exemption as specified in Exhibit A. FINRA has announced that it may propose removal of all maintenance margin requirements.

Adopted Rule 4210 requirements differ from the TMPG requirements in that the mark-to-market margining requirements only apply to Covered Agency Transactions, include a maintenance margin requirement for some accounts, and are not bilateral. Although the rule does not require a Dealer to post collateral to its counterparty, the Dealer and counterparty may agree (and most do) to bilateral margining.

The Master Securities Forward Transaction Agreement

Most Dealers and counterparties transact MBS forwards under a master agreement, a prime brokerage arrangement, or a securities custody account arrangement, although pending final effectiveness of Adopted Rule 4210 some counterparties continue to trade with Dealers and others without a formal agreement. Adopted Rule 4210 requires that Dealers and their counterparties enter into a formal agreement that sets out the margin requirements. The Master Securities Forward Transaction Agreement (the “MSFTA”) is an industry-standard master agreement governing the purchase and sale of forward and other delayed delivery securities and margining. The first version of the MSFTA was published by the Securities Industry Financial Market Association (“SIFMA”) in 1996. In anticipation of the TMPG guidelines, SIFMA, with input from sell-side and buy-side market participants, published a new version of the MSFTA in late 2012, which has supplanted the 1996 agreement. One of the more notable differences between the two versions is that the 1996 version did not require variation margining unless elected by the parties in an annex and allowed either one-way or bilateral margining. The 2012 version includes bilateral variation margining in the body of the agreement.

The MSFTA, like most other master agreements, sets out basic rules for both present and future transactions for an indefinite period of time.

The body of the MSFTA provides, on a reciprocal basis, the basic legal protections that are essential for forward transaction market participants, including:

- how parties enter into transactions and standard provisions for delivery of, and payment for, securities covered by the MSFTA;
- representations and warranties;
- choice of law, jurisdiction and other legal matters,
- two-way variation margining;
- optional initial or maintenance margining, and, most importantly
- events of defaults and remedies.

The Payment and Transfer Obligations

Under the MSFTA either party can be the buyer or the seller in the transaction and either party can initiate the transaction. However, neither party is required to enter into a transaction simply by virtue of having an executed MSFTA; transactions require a separate confirmation of the trade between the parties. The settlement of a transaction under the MSFTA is made on a delivery vs payment basis on the settlement date, i.e., seller does not transfer securities until payment is received.

Representations

The parties make typical representations and warranties which are repeated on each day on which the parties enter into a transaction under the MSFTA. They include:

- due authorization for execution, delivery and performance of and under the agreement;
- each party is acting as principal, unless otherwise agreed;
- the person signing the agreement of behalf of each party is duly authorized to do so;
- all required authorizations have been obtained; and
- the execution, delivery and performance of the agreement and the transactions do not violate any law, ordinance, charter, by-law or rule that is applicable to the relevant party.

Two Way Margining

A party (the "pledgee") is entitled to call for collateral from the other party (the "pledgor") whenever the collateral it currently holds, if any, is not sufficient to cover the net loss it would incur if the transactions were cancelled on that day and the party were to enter into replacement transactions (the "*Net Unsecured Forward Exposure*"), plus any initial margin or maintenance margin as agreed.

Conversely, if a party holds collateral greater than the amount of the loss it may suffer and the agreed upon initial/maintenance margin, then the other party can request the return of excess collateral (the "*Excess Forward Collateral Amount*"). These transfers are subject to same-day transfer timing, with a 10 am notification deadline and to the negotiation of minimum transfer amounts ("MTA") and threshold amounts (adopted Rule 4210 will ban threshold amounts for the counterparty and limit MTA's to a maximum of $250,000 per customer).

Under the MSFTA, the pledgee of collateral is entitled to repledge or otherwise use any and all collateral. However, repledge or use of collateral does not relieve the pledgee of its obligation to return collateral to the pledgor in accordance with the terms of the MSFTA.

Events of Default and Remedies

As a result of specific circumstances, as outlined in Paragraph 2(j) of the MSFTA, occurring with respect to its counterparty (each an "Event of Default"), the non-defaulting party is entitled to exercise its rights under the MSFTA and terminate all, but not less than all transactions entered into under the MSFTA. The non-defaulting party may determine the termination payment by reference to the cost of replacement transactions (whether it enters into any such transactions) and the cost of terminating hedges. The non-defaulting party's costs can include fees, expenses and commissions.

The termination payment is owed by whichever party was out-of-the money upon termination, regardless of which party defaulted. However the MSFTA does require that in the event the non-defaulting party owes the defaulting party, the defaulting party must provide a full release to the non-defaulting party of all liability of the non-defaulting party under or relating to the MSFTA prior to the non-defaulting party being required to make its payment. This provision is not found in most other master agreements.

Mini Close-out

While an Event of Default gives the non-defaulting party the right to terminate all transactions, if the Event of Default is a failure by a seller to deliver securities on the settlement date, the parties can elect that such failure will not be an Event of Default. Instead, buyer will exercise its remedies only with respect to the transaction to which the failure relates ("Mini Close-out").

Specifically, Mini Close-out allows the buyer to:

> (a) require seller to repay any amount buyer paid to seller in respect of the transaction or/and transfer Eligible Forward Collateral to eliminate any exposure buyer has to seller with respect to that transaction; and
>
> (b) elect, at any time while the failure to deliver continues, to terminate the failing transaction (after the relevant cure period, if any, has elapsed) in accordance with the terms of the MSFTA.

If the seller fails to fulfill its obligations, if any, under (a) or (b) above, taking into consideration any cure period, the buyer is then entitled to declare an Event of Default pursuant to which all transactions would be subject to termination.

Annexes and Amendment

As with other master agreements, changes to the MSFTA are not made in the body of the standard form agreement but rather in a separate document, in this case - *Annex I: "Supplemental Terms and Conditions."*

In addition, there are other annexes which can be applied to the MSFTA:

- *Annex II: "Names and addresses for Communication between the Parties"*. In this Annex the parties list their names, addresses and contact information.
- *Annex III: "Party Acting as Agent"*. This Annex is applied when an agent is acting on behalf of one of more principals. The Annex provides additional representations, obligations, and limitations on liability for the agent.

Lastly, to facilitate compliance with Adopted Rule 4210, SIFMA has published the "Form of Amendment to Master Securities Forward Transaction Agreement to Conform with FINRA 4210" (the "4210 Amendment") which allows for the seamless amendment of existing MSFTAs to make them compliant with Adopted Rule 4210.

EXHIBIT A: Chart A - Counterparty Type Exemptions

The two charts below set-out which counterparties and/or which transactions are not subject to Adopted Rule 4210's requirement for customers to post maintenance margin as well as the counterparties and transactions that may or may not be subject to mark-to-market margining. Adopted Rule 4210 currently defines "Exempt Accounts," which are not required to post maintenance margin to Dealers, and requires that most non-Exempt Accounts post maintenance margin to Dealers (with certain exceptions). The major exceptions are the Cash Account exemption and the Small Account exemption described below.

Chart A - Counterparty Type Exemptions

Mark to Market Margin	Maintenance Margin	Type of Counterparty	Classification
Required	Not Required	Dealer that is a FINRA member	Exempt Account
Required	Not Required	an entity that has a net-worth of at least $45 million and financial assets of at least $40 million; and either (i) is a reporting issuer under the Securities and **Exchange Act** (or if not subject to SEC reporting requirements, is a person with respect to which certain required information is publicly available) or (ii) makes available to the Dealer current information regarding such person's ownership, business, operations and financial condition (including such person's current audited statement of financial condition, statement of income and statement of changes in stockholder's equity, assets under management or comparable financial reports), as reasonably believed by the Dealer to be accurate, sufficient for the purposes of performing a risk analysis in respect of the entity.	Exempt Account
Required	Not Required	Mortgage banker that uses Covered Agency Transactions to hedge its pipeline of mortgage commitments	Exempt Account
Required	Not Required	a bank	Designated Account (all Designated Accounts are Exempt Accounts)
Required	Not Required	a savings association insured by the Federal Deposit Insurance Corporation	Designated Account
Required	Not Required	an insurance company as defined in the Investment Company Act	Designated Account
Required	Not Required	an investment company registered with the Securities Exchange Commission under the **Investment Company Act**	Designated Account
Required	Not Required	a state or political subdivision thereof	Designated Account

Required	Not Required	a pension or profit-sharing plan subject to the Employee Retirement Income Security Act or of an agency of the U.S. or of a state or political subdivision thereof.	Designated Account
Not Required	Not Required	Federal banking agency, central bank, multinational central bank, foreign sovereign, multilateral development bank or the Bank for International Settlements	Accounts subject to an exemption

Chart B - Transaction Type Exemptions

Mark to Market	Maintenance Margin	Type of Transactions	Classification
Not Required	Not Required	Non-Exempt Account with gross open positions in Covered Agency Transactions of $10 million or less and settlement is in the month of the trade or the following month and the parties settle DVP or for cash. [Does not apply if counterparty engages in dollar rolls, round robin trades or other financing techniques.]	Small Account Exemption
Required	Not Required	Non-Exempt Account where settlement of the trade is in the month of the trade or the following month and Counterparty regularly settles DVP or for cash. [Does not apply if counterparty engages in dollar rolls, round robin trades or other financing techniques.]	Cash Account Exemption
Not Required	Not Required	Unmargined mark-to-market less than $250,000	
Not required	Not required	Transactions cleared through a registered clearing agency (If subject to the margin requirements of that clearing agency)	