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Invested in America

asset management group

2 May 2014

Mr Barry King
OTC Derivatives and Post Trade Policy
Financial Conduct Authority
25 The North Colonnade
Canary Wharf
London
E14 5HS
England

Re: Request for comments on the treatment of mortgage-backed securities (''MBS'') traded on the To-Be-Announced market ("TBA trades")

Dear Mr King

1. Introduction and summary

The Asset Management Group (the "**AMG**")[1] of the Securities Industry and Financial Markets Association ("**SIFMA**") welcomes this opportunity to contribute to your consideration of whether TBA trades should be classed as "derivative contracts" as defined in EMIR[2], meaning within points (4) to (10) of Section C of Annex I to MiFID[3].

As detailed below, the AMG believes that TBA trades should not be classed as derivative contracts for the following reasons.

(a) TBA trades are appropriately classified as spot trades (cash market trades) as they settle within the standard settlement cycle of the securities being purchased.

(b) In the alternative, TBA trades should be classified similarly to other transaction types that include relatively long periods of settlement and that are not considered to be derivative contracts.

(c) There is no regulatory imperative for classifying TBA trades as derivatives as, even without such classification, TBA trades would fall within point (1) of Section C of Annex I to MiFID.

(d) The TBA market is a distinct market based in the United States, distinguished as relating to the purchase of securities issued and guaranteed by three US government owned or chartered agencies. The US does not treat TBA trades as derivatives (i.e., TBA trades were excluded from the definition of "swaps" and "security-based swaps" by the US regulators). Classifying TBA trades as derivative contracts in Europe would disrupt this US market by creating inconsistency between the regulatory regimes in the US and the EU and would potentially disadvantage EU investors that wish to invest in these US government backed assets.

[1] The AMG's members represent US asset management firms whose combined assets under management exceed $30 trillion. The clients of AMG member firms include, among others, registered investment companies, endowments, state and local government pension funds, private sector Employee Retirement Income Security Act of 1974 pension funds and private funds such as hedge funds and private equity funds.
[2] The European Market Infrastructure Regulation (648/2012).
[3] The Markets in Financial Instruments Directive (2004/39/EC).

2. Description of TBA trades and the TBA market

TBA trades relate to a distinct market in the US. Fannie Mae, Freddie Mac and Ginnie Mae[4], agencies owned or chartered by the US government, issue (or guarantee, in the case of Ginnie Mae) MBS ("**agency MBS**") in high volume through a routine, standardised process (approximately USD 1.6 trillion of agency MBS is issued annually).[5] Agency MBS securitisation programs involve strict, well understood criteria regarding mortgage eligibility. Agency MBS are guaranteed by the relevant agency and each agency is supported by the US government.

The certainty for market participants resulting from this process supports liquidity in the TBA market (participants can arrange to buy agency MBS before the given agency MBS is issued, as described below) which in turn allows mortgage sellers, in effect, to fix the interest rate at the time the mortgage is offered to the customer, rather than the mortgage seller or borrower being exposed to movements in rates between the offer of the mortgage and its acceptance. The benefit to the mortgage customer has been estimated to be an interest rate in the order of 10 to 25 basis points below that which mortgage customers would have to pay if the TBA market did not exist.[6]

A TBA trade is the purchase of a given volume of agency MBS meeting certain criteria (issuer, maturity, coupon, price, par amount and settlement date). There are four standard settlement dates per month for TBA trades, the date aligning with the relevant standard settlement date for the type and maturity of the agency MBS (e.g., Ginnie Mae, 30 year term MBS). A TBA trade can be entered into on any trading day, typically up to two months prior to settlement, allowing market participants to buy (and sell) agency MBS flexibly in the period up to the fixed monthly settlement date. Two days prior to settlement, the seller notifies the buyer of the specific agency MBS (including CUSIP) to be delivered and then delivers on the settlement date, the earliest date available for delivery of these securities.

The contract terms provide for physical delivery of the agency MBS (rather than for speculation on a change of value of the underlying) and contain a number of features to ensure such physical delivery, with cash compensation available in the event of a failure to deliver.[7] TBA trades are documented under an industry standard master agreement[8] and are margined but these factors are not in any way determinative of a derivative transaction either generally or with reference to relevant legislation.

3. Classification of TBA trades

The definition of derivative in EMIR references points (4) to (10) of Section C of Annex I to MiFID. MiFID does not attempt an all-inclusive definition of derivatives relating to securities, the relevant point (C(4)) simply states "options, futures, swaps, forward rate agreements and any other derivative contracts relating to securities … which may be settled physically or in cash".

In the absence of further definition in respect of derivatives in relation to securities, it is perhaps better to consider what is not a derivative for the purposes of EMIR.

3.1 TBA trades are appropriately classified as spot trades as they settle within the standard settlement cycle of the securities being purchased.

It is generally accepted that physically settled spot contracts are not derivatives.[9] While "spot contract" is not defined in respect of securities, a definition does exist in respect of commodities and

[4] The Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation and the Government National Mortgage Association.
[5] The figure given is for 2013, please see http://www.sifma.org/uploadedFiles/Research/Statistics/StatisticsFiles/SF-US-Mortgage-Related-SIFMA.xls?n=96857.
[6] http://www.newyorkfed.org/research/epr/2013/1212vick.pdf.
[7] See TMPG Agency MBS Fails Charge, available here:
http://www.newyorkfed.org/tmpg/Agency%20debt%20and%20MBS%20fails%20charge%20trading%20practice%2003_28_2013.pdf.
[8] The Master Securities Forward Transaction Agreement, published by SIFMA.
[9] For example, as shown in the current European Commission Consultation on FX financial instruments:
http://ec.europa.eu/internal_market/consultations/2014/foreign-exchange/index_en.htm.

is potentially instructive. Spot contracts, in the context of commodities, are distinguished by having a delivery period within the longer of two trading days and "the period generally accepted in the market for that commodity, asset or right as the standard delivery period".

As described above, TBA trades are essentially a purchase of an agency MBS that have not been identified at the time the TBA trade is entered into. Accordingly, such a security cannot be delivered until it has been identified so it can be seen that the "period generally accepted in the market … as the standard delivery period" is the period from trade date to settlement date, the settlement date being the earliest date on which the previously unidentified agency MBS is available for delivery. Indeed, in many cases the securities that are delivered to fulfil a TBA contract have not been issued at the time of the initial TBA trade. These delivery periods developed in order to maximize the efficiency of the clearance and settlement of the large volume of transactions in this market and are also related to the standardised and routine processes of the US government agencies.

3.2 In the alternative, TBA trades should be classified similarly to other transaction types that include relatively long periods of settlement and which are not considered to be derivative contracts.

TBA trades are similar to "when issued" trading such as where equities and bonds can be purchased on a to-be-issued basis (sometimes known as "grey market" trading). Settlement is timed to the relevant issue date, creating a standard delivery period greater than the deliverable will have once it is issued and freely available for transfer in the market.

Other examples of transactions which include longer settlement periods than the deliverable would otherwise have include repurchase and securities lending transactions and certain standard arrangements in mergers and acquisitions.

The longer settlement cycle seen in such transactions does not in any way mean that these transactions are or should be treated as derivative transactions. They would usually be viewed as cash market transactions instead.

The traditional distinction that exists between derivatives and "long settlement transactions" in capital requirements regulation may also be considered to support such differing treatment.[10]

3.3 There is no regulatory imperative for classifying TBA trades as derivatives as, even without such classification, TBA trades would fall within point (1) of Section C of Annex I to MiFID.

TBA trades fall within point (1) of Section C of Annex I to MiFID (transferable securities) so an existing regulatory structure and related market infrastructure already exists. Classifying TBA trades as derivatives would require market participants to put in place new systems and processes, many of which would be unnecessary given existing well-established industry practice, guidelines and processes.

3.4 The TBA market is a distinct US market

The home jurisdiction of this market is the US and trading in this market is mainly offered by US dealers. The US regulators do not classify TBA trades as derivatives, as shown by the joint final rulemaking of the Commodity Futures Trading Commission and the Securities and Exchange

[10] "Long settlement transactions" are defined in Article 272(2) of Regulation (EU) No 575/2013 to be "transactions where a counterparty undertakes to deliver a security, a commodity, or a foreign exchange amount against cash, other financial instruments, or commodities, or vice versa, at a settlement or delivery date specified by contract that is later than the market standard for this particular type of transaction or five business days after the date on which the institution enters into the transaction, whichever is earlier". Long settlement transactions were also a feature of Directive 2006/48/EC.

Commission.[11] While differences do of course exist between the regulatory framework in the US and the EU, the EU taking a different approach in the case of TBA trades would:

(a) create an international inconsistency in respect of TBA trades between two of the most important markets, setting back attempts by regulators to improve regulatory convergence across borders;

(b) disadvantage EU investors who wish to buy these well-established securities issued and guaranteed by US government backed institutions (due to potentially higher levels of collateralisation and capital charges as well as by requiring the EU investor and the US entity that trades with the EU investor to comply with the requirements of EMIR and other EU regulation that applies to derivatives); and

(c) thereby negatively affect this distinct US market and the benefits it brings to US homeowners.

We appreciate your consideration of our response and stand ready to provide any additional information or assistance that you might find useful. Should you have any questions, please do not hesitate to contact Matt Nevins at 1-212-313-1176 or Chris Killian at 1-212-313-1126.

Sincerely

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[11] Federal Register Vol. 77, No. 156 dated 13 August 2012, Commodity Futures Trading Commission 17 CFR Part 1, Securities and Exchange Commission 17 CFR Parts 230, 240 and 241, http://www.cftc.gov/LawRegulation/FederalRegister/FinalRules/2012-20962.