February 24, 2017

Eduardo A. Aleman
Assistant Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

RE: FILE NUMBER SR-FICC-2017-001

Dear Mr. Aleman:

Ronin Capital, LLC ("Ronin") appreciates the opportunity to comment on a proposed rule change by the Fixed Income Clearing Corporation ("FICC") to modify the Government Securities Division ("GSD") Rulebook to include a minimum volatility calculation called the "Margin Proxy." The FICC claims this rule change (hereafter referenced as the "Margin Proxy Rule")[1] is needed to correct the ineffectiveness of the current model-based volatility calculation ("Current Volatility Calculation") as measured during the fourth quarter of 2016. This ineffectiveness caused an underestimate in margin posted to the Required Fund Deposit, which "yielded back-testing deficiencies beyond FICC's risk tolerance."[2] Thus, FICC is requesting that the Securities and Exchange Commission (the "Commission") accelerate the effectiveness of this proposed rule change.

Ronin believes this hasty response is unwarranted. We believe that any back-testing deficiencies observed during the fourth quarter of 2016 were likely caused by idiosyncratic volatility surrounding the U.S. presidential election, rather than being indicative of a major failure in the Current Volatility Calculation. Ronin certainly understands that risk models need to evolve or be replaced as circumstances change. However, we believe the market response to the U.S. presidential election was not representative of a volatility regime change requiring an immediate response by the FICC. Current regulation, which requires a registered clearing agency to "limit its exposures to potential losses from defaults by its participants under normal market conditions,"[3] would seem to provide flexibility with respect to rushing any new VaR model changes into effect. This is particularly important given the FICC acknowledges that the "proposed rule changes associated with the Margin Proxy and the Coverage Charge could have an impact upon competition."[4]

1 SEC Release No. 34-79958; File No. SR-FICC-2017-001
2 SEC Release No. 34-79958 p. 4
3 SEC Release No. 34-79958 p. 9
4 SEC Release No. 34-79958 p. 11

On January 20th, 2017, Ronin sent a letter to the FICC (the "Ronin Letter") expressing general concerns related to this potential rule change. This letter was later made public as part of FICC's Margin Proxy Rule and attached to the rule filing as "Exhibit 2."[5] In the Ronin Letter, we express general concerns related to:

- the appropriateness of adding the Margin Proxy,
- the need for an abbreviated rule approval process, and
- a general lack of transparency.

We believe these concerns remain largely unresolved. While the FICC has provided some data, and is currently providing support to help us replicate the Margin Proxy, significant issues remain unaddressed. The Margin Proxy Rule materially impacts us, but in a rather unintuitive manner. Ineffectiveness of the Current Volatility Calculation during the fourth quarter of 2016 is stated as the reason driving the need to add the Margin Proxy to the GSD Rulebook. And yet, <u>the addition of the Margin Proxy does not materially impact our required margin during the fourth quarter of 2016</u>. In contrast, <u>the Margin Proxy does materially impact our required margin during the first three quarters of 2016 - a period of time that does not concern the FICC</u>. <u>In our opinion, this is the very definition of an unfair competitive burden.</u> The Margin Proxy Rule has its greatest material impact on Ronin (and likely other firms as well) during periods of time that were not concerning to the FICC. Thus, we believe the FICC should improve its VaR model and back-testing methodology to respond to actual risks, versus proposing a solution which generally requires Netting Members to post additional margin for no apparent reason.

<u>Due to concerns related to an unfair competitive burden, Ronin respectfully requests that the Commission deny the FICC's request to accelerate the effectiveness of this proposed rule change</u>. Ronin believes it is important for GSD members to have the time to properly prepare for any business impact this proposed rule change may impart. Ronin also believes proposed changes to the FICC VaR model, as described in this rule filing, are poorly designed and likely impose a competitive burden on smaller firms. Smaller non-bank proprietary firms, like Ronin, are required to efficiently manage capital. We have no customers to pass along additional margin requirements. Our margin contributions to the Required Fund Deposit are already excessive multiples of our internal VaR. Thus, <u>we believe the Margin Proxy Rule will disrupt our business in an anticompetitive manner for no real purpose</u>. The remainder of this comment letter is intended to expound on these concerns in more detail. Before continuing, however, it is likely appropriate to provide some background information regarding Ronin Capital, LLC.

Background

Ronin Capital, LLC is a registered broker-dealer headquartered in Chicago. We engage in proprietary trading and do not have any customers. We trade a diversified list of products as well as deploy an equally diversified list of strategies among the various assets classes we trade. We are active participants in the U.S. Treasury market and are self-clearing members of both the Fixed Income Clearing Corporation and the Chicago Mercantile Exchange. Our trading strategies within the U.S. Fixed Income market would be best characterized as relative value and basis trading. Because we trade our own money, we are acutely cognizant of the importance of managing our own risk. Given we hold overnight positions, we have a vested interest in the proper functioning of the U.S. Treasury market. We traditionally have served as

[5] SEC Release No. 34-79958 Exhibit 2

"shock absorbers" and liquidity providers during the nearly two decades we have been involved in trading U.S. Treasuries, providing liquidity when volatility (and often opportunity) presents itself in the market.

Lack of Transparency

Ronin believes there are flaws in the Margin Proxy Rule. These flaws will be described later in this comment letter. First, it is important to express a sense of frustration with the attempt of the FICC to push through a rule change in an extremely abbreviated time period without providing critical information to Netting Members. Ronin is still in the process of trying to understand the impact of this rule change on our margin requirements. We are currently waiting on the FICC to provide additional requested data, which will help us analyze and confirm the impact of this rule change on our historical margin requirements. At the same time, despite having incomplete information, we are compelled to write a comment letter (due by February 24, 2017) asserting that this rule change will present an unclear and potentially significant competitive burden on our firm. The timeline of events associated with this rule filing is extremely abbreviated and unwarranted in our opinion - 45 days between first high-level disclosure and the end of the comment period. The first relevant quantitative data regarding this rule filing (a two-page chart covering only two months of activity) was delivered by the FICC on the same day as the rule filing. Is the FICC under such dire threat that transparency with Netting Members is merely an afterthought?

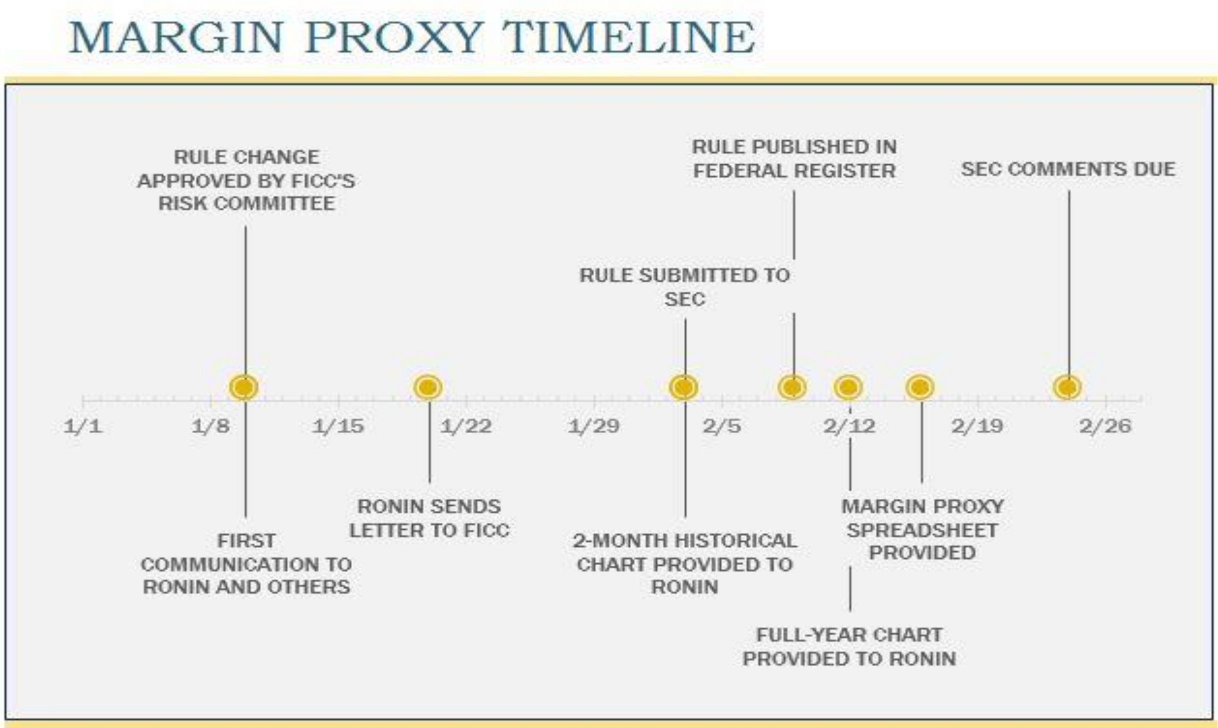
Timeline

On January 10, 2017, the FICC convened a meeting with a small group of Netting Members to disclose high-level details of the proposed Margin Proxy Rule for the first time. On this same day, this proposed rule change was "approved by the Risk Committee of FICC's Board of Directors."[6] Ten days later, on January 20, 2017, Ronin sent a letter to the FICC, expressing various concerns related to the high-level details that had been imparted regarding the Margin Proxy model.

On February 3, 2017, the FICC submitted the Margin Proxy Rule to the Commission.[7] On that same day, Ronin received its two-month GSD Var Charge Impact Study (a two-page chart) from the FICC. The rule filing states that FICC believes that it has provided Netting Members with sufficient information and advance notice regarding the proposed changes.[8]

Is the same-day delivery of an impact study considered "advance notice?" Is a two-month impact study in the form of a two-page chart "sufficient information?" As mentioned in the Ronin Letter, the FICC conducted a much more extensive study for the Mortgage-Backed Securities Division (MBSD) before filing for a rule change FICC conducted a study of the impact of implementing the proposed sensitivity approach on each Clearing Member's portfolio. The study, which covered two and a half years, revealed that the sensitivity approach is more responsive to changing market conditions.[9]

[6] FICC-2017-001 p. 3
[7] https://www.sec.gov/rules/sro/ficc.shtml
[8] SEC Release No. 34-79958 p. 19
[9] SEC Release No. 34-79491; p. 28



We believe GSD Netting Members are entitled to the same level of disclosure that was provided to MBSD Netting Members. This is particularly true, when an impact study of two months does not represent "sufficient information" regarding the proposed changes. Ronin's two-month impact study, conducted from October 31 through December 30, 2016, showed very little impact on our past margin requirements - around 1% average difference in total. However, at our request, the FICC extended our impact study from January 5, 2016 through January 31, 2017 - a little over a year. This more extended study, in contrast, showed an increase in our average margin requirements of nearly 22%. The disparity between these two studies conflicts directly with the assertion, made in the rule filing, that the FICC had provided each Netting Member with reports that reflect the impact that the proposed change would have on such Netting Member's Required Fund Deposit. [10]

Clearly, a two-month study was not indicative of the impact of this rule change on our firm. <u>If we had not requested additional information, we would have been greatly misled regarding the impact of this proposed change.</u> This extended study was only recently provided to Ronin - on February 12, 2017. At present, we are still awaiting additional data from the FICC in order to further assess the historical impact of this rule change. FICC is also currently working with our risk team to help us replicate the Margin Proxy, so that we can conduct our own historical scenario analysis. The fact that these items are still being worked on seems to conflict with the statement that FICC believes that all Netting Members have the ability to manage their obligations based on the information that FICC has provided in connection with this proposed change.[11]

Given these circumstances, is it appropriate to accelerate the effectiveness of this proposed rule change?

[10] SEC Release No. 34-79958 p. 20
[11] SEC Release No. 34-79958 pp. 20-21

Model Appropriateness

The FICC's statement of purpose for the proposed rule change is:

- FICC is proposing to introduce the Margin Proxy, which would constitute a Netting Member's daily VaR Charge in circumstances where the Margin Proxy would be greater than the Current Volatility Calculation. In circumstances where the Margin Proxy is applied by FICC, FICC also proposes to reduce the Coverage Charge by the amount that the Margin Proxy exceeds the sum of the Current Volatility Calculation and Coverage Charge, but not by an amount greater than the total Coverage Charge, as further described below.[12]

In other words, the FICC has two different VaR models. FICC will choose whichever model requires the larger daily VaR Charge for a given Netting Member. This larger number will become that Netting Member's Required Fund Deposit. The rationale for this methodology is explained:

- FICC believes that the proposed changes associated with the Margin Proxy and the Coverage Charge would help to ensure that each Netting Member's Required Fund Deposit achieves a 99 percent confidence level and the proposed changes would mitigate potential losses to FICC and non-defaulting Netting Members associated with the liquidation of a defaulted Netting Member's portfolio.[13]

We believe any approach requiring two separate VaR models is flawed and should raise a red flag with the Commission. Choosing the larger result between two different models may help the FICC obtain a 99 percent confidence level for all Netting Member's Required Fund Deposits, but it doesn't demonstrate that either model is particularly effective or accurate. In order to obtain a 99 percent confidence level for all Netting Members, the FICC is certainly requiring much larger Required Fund Deposits than necessary for some Netting Members. This likely presents an anticompetitive burden on those Netting Members with higher costs of capital. The FICC attempts to address this issue by stating:

- FICC does not believe that the proposed rule changes associated with the Margin Proxy and Coverage Charge would impose a significant burden on competition because the increase in the Required Fund Deposit would be in direct relation to the market risk presented by each Netting Member's Margin Portfolio.[14]

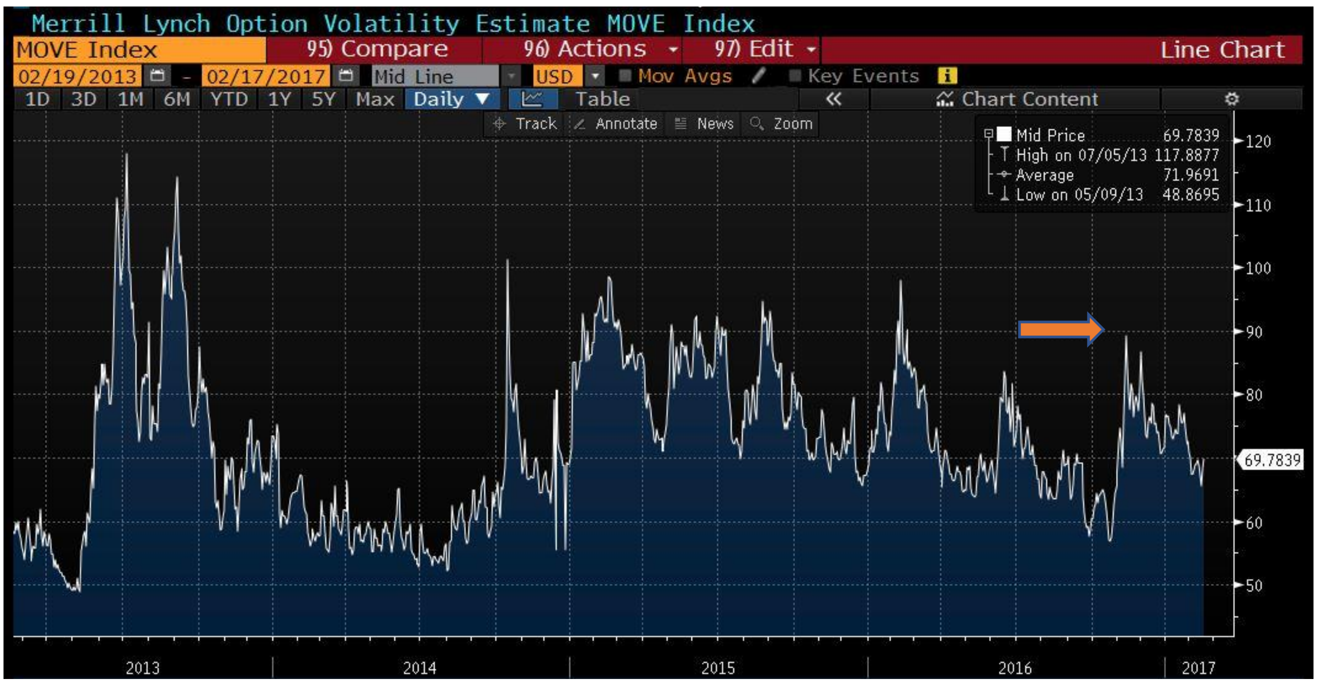
What does the FICC mean by "market risk?" We believe the fact that the FICC is deploying two different VaR models, and choosing the larger of the two, shows that the FICC is not comfortable with the effectiveness of either model. Which model reflects the true level of "market risk?" The fact that two separate VaR models are needed would seem to imply that any "direct relation" between Required Fund Deposits and market risk is tenuous at best. How can the FICC claim that there is not a competitive burden?

[12] SEC Release No. 34-79958 p. 20
[13] SEC Release No. 34-79958 p. 15
[14] SEC Release No. 34-79958 p. 12

Finally, we believe it is important to examine the precipitating cause driving the need for this rule change as described by the FICC:

> During the fourth quarter of 2016, FICC's Current Volatility Calculation did not respond effectively to the level of market volatility at that time, and the VaR Charge amounts that were calculated using the profit and loss scenarios generated by the Current Volatility Calculation did not achieve back-testing coverage at a 99 percent confidence level. As a result, the Required Fund Deposit yielded back-testing deficiencies beyond FICC's risk tolerance. Therefore, FICC proposes to use the Margin Proxy as the VaR Charge when the Margin Proxy calculation would exceed the Current Volatility Calculation.[15]

Certainly, volatility increased in the days surrounding the U.S. presidential election. However, we don't believe this volatility was particularly unusual or extreme. The Merrill Lynch MOVE Index (courtesy of Bloomberg) demonstrates an increase in volatility surrounding the election. As demonstrated below, this volatility is neither unusual nor lasting.



Similarly, an examination of historical volatility of the USGG10YR Index (also courtesy of Bloomberg) over three-day and thirty-day periods does demonstrate a spike in volatility around the U.S. presidential election. Yet again, this volatility isn't particularly noteworthy. In fact, the volatility surrounding BREXIT at the end of June is much more significant.

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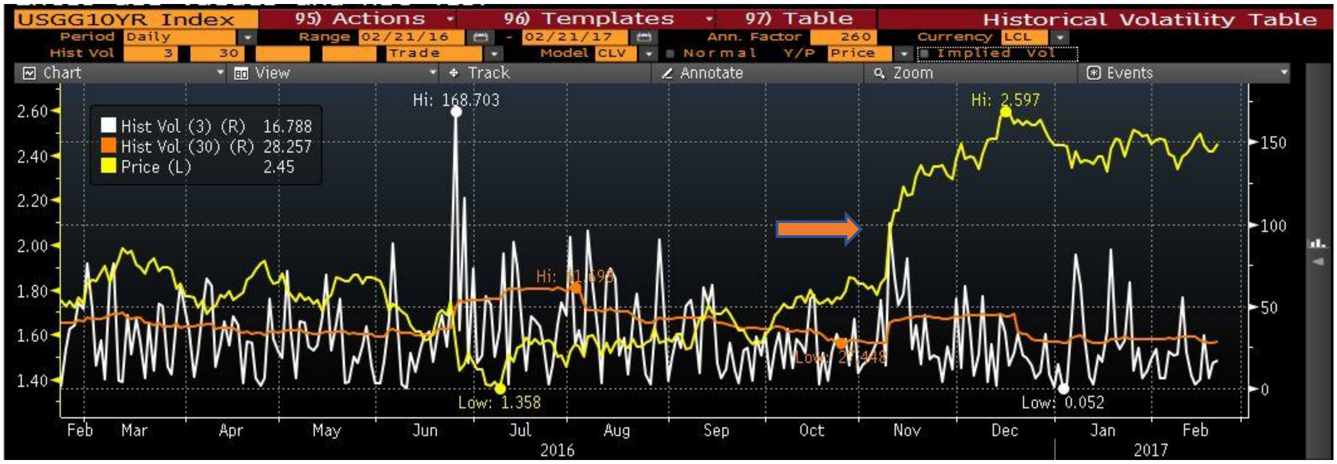
[15] SEC Release No. 34-79958 p. 4



So why does the FICC cite fourth quarter market volatility as precipitating the need for implementing the Margin Proxy? It is difficult to discern any significant change in the U.S. Treasury market overall that began in the fourth quarter, other than a modest increase in yield levels. And yet, we believe it is possible that there may be specific faults present in FICC's VaR models, which may lead the FICC to conclude that Netting Members present risks that, in reality, do not exist. We have discussed several of these potential issues with the FICC in the past. Specifically, we speculate that inefficiencies of the Cross-Margining Agreement with the Chicago Mercantile Exchange (CME),[16] as well as timing-related issues associated with intraday settlement,[17] might lead the FICC to incorrectly measure Netting Member risk. Naturally, these hypotheses are pure conjecture on our part and have neither been confirmed nor rejected by the FICC. Ronin has no insight into the risks presented to the FICC by other Netting Members. However, we certainly can relate our own specific concerns regarding the Margin Proxy Rule - we specifically believe this proposed rule change presents a competitive burden to our firm.

Problems with the Back-testing Model

Ronin has mentioned lack of transparency as a general concern. During the fourth quarter of 2016, the FICC states that the Required Fund Deposit had "yielded back-testing deficiencies beyond FICC's risk tolerance."[18] But why? What is the actual cause of this back-testing deficiency? FICC has not been transparent about the cause. Perhaps the FICC does not know. Is the Margin Proxy Rule just an attempt to blindly grab more margin without understanding the reason why Netting Members are presenting a "back-testing deficiency?" Again, we can only speculate on the cause, because of a lack of transparency, but we believe flaws in the back-testing model may lead the FICC to believe it is exposed to Netting Member risk that does not exist.

FICC describes how the back-testing process works:

> FICC employs daily back-testing to determine the adequacy of each Netting Member's Required Fund Deposit. The back-testing compares the Required Fund Deposit for each Netting Member

[16] Despite being introduced by the CME in 2010, Ultra T-Bond futures are still not included in the Cross-Margining Agreement.
[17] Long positions that are funded in the Net via overnight repo are double counted for risk purposes until the FICC either delivers these securities or fails to do so.
[18] SEC Release No. 34-79958 p. 4

> with actual price changes in the Netting Member's Margin Portfolio. The Margin Portfolio values are calculated using the actual positions in such Netting Member's Margin Portfolio on a given day and the observed security price changes over the following three days. These back-testing results are reviewed as part of FICC's VaR model performance monitoring and assessment of the adequacy of each Netting Member's Required Fund Deposit.[19]

First, we believe it is critical to ensure that each Netting Member's Margin Portfolio is correct. This would seem to be straightforward, but there are some details here that are important. The FICC views its risks in isolation. Thus, the FICC may know that a Netting Member is completely hedged with interest rate futures (because of the Cross-Margining Agreement with the CME), but the back-testing analysis does not take this information into consideration. If a Netting Member has a portfolio that is long U.S. Treasuries and short interest rate futures, a large market selloff in U.S. Treasuries may result in a back-testing violation that has nothing to do with actual risk. The Netting Member is hedged, but the FICC ignores this information when conducting back-testing. If the Margin Portfolio included interest rate futures, it is certain that many Netting Members would easily meet FICC's back-testing requirements. Isn't the FICC tasked with protecting Netting Members from risk of loss? Or is the goal to accumulate as much margin as possible?

Secondly, we believe there may be some specific peculiarities with calculating each Netting Member's Margin Portfolio that are affected by the repo settlement process. If FICC's back-testing confidence levels are calculated intraday, there is the possibility that many Netting Members are viewed as presenting risk to the FICC that is double their actual risk. For example, if a Netting Member has a position of 100MM of the current 10-year U.S. Treasury note and executes an overnight repo transaction to finance this position, the FICC treats this as a position of 200MM for intraday VaR calculations, until the repo transaction settles. When, and if, this overnight repo transaction settles, this additional "double" risk disappears with respect to VaR calculations. Does the FICC in effect "double count" each Netting Member's Margin portfolio with respect to conducting back-testing violations? If true, this creates an odd situation beyond each Netting Member's control. In this example, the Netting Member is dependent on the FICC to deliver its 10-year U.S. Treasury notes to complete repo settlement. The FICC might fulfill this delivery obligation at 8:32AM, or 2:46PM, or not at all. The Netting Member has no control of this arbitrary situation. In simple terms, the Netting Member is unable to deliver to a repo counterpart until the FICC first delivers to the Netting Member. We are not sure whether each Netting Member's Margin Portfolio is impacted by such intraday settlement risk, but we believe any back-testing violations arising from intraday double counting are certainly suspect, when the FICC is on both sides of the transaction.

Finally, we believe it is extremely important to clarify how a firm can violate FICC's "99 percent confidence level (i.e., greater than two back-testing deficiency days in a rolling twelve-month period)."[20] <u>Because the FICC conducts back-testing through "observed security price changes over the following three days,"[21] a large market move in either direction is triple counted.</u> <u>We speculate that the single relatively large market move that occurred on November 9th, 2017 (the day after the U.S. presidential election) accounted for three back-testing violations for many Netting Members</u>. And because three back-testing deficiency days in a

[19] SEC Release No. 34-79958 p. 4
[20] SEC Release No. 34-79958 p. 4
[21] SEC Release No. 34-79958 p. 4

rolling twelve-month period constitute violation of FICC's 99 percent confidence level, suddenly the FICC needs to change its VaR model and require more margin from its Netting Members. We don't believe this is reasonable. Is the Current Volatility Calculation flawed, or rather, is the back-testing methodology in dire need of revision? Isn't this particularly relevant when there are questions regarding the method by which each Netting Member's Margin Portfolio is calculated? Is the FICC interested in mitigating actual risk? Or is the FICC only interested in grabbing more margin because of an idiosyncratic price move following the U.S. presidential election?

Specific Competitive Burden

Ronin has no ability to analyze the specific impact of the Margin Proxy Rule on other Netting Members. And yet, discussions we have had with other similar-type Netting Members validate our concerns. These other Netting Members (generally smaller firms) also individually requested an extended GSD VaR Impact Study data from the FICC (beyond two months) and reported similar negative effects. In fact, some Netting Members reported even larger percentage increases in their revised margin requirements over the past year. Did the FICC provide Netting Members with only a small sample size (two months) knowing that a more extended GSD VaR Impact Study would present a far more negative picture?

While our conversations with other Netting Members were qualitative, we certainly have the capability to more quantitatively analyze the impact of this rule change on our own firm - at least within the context of the current information provided to us by the FICC (i.e. as of February 24, 2017). Ronin believes the Margin Proxy Rule presents a specific competitive burden to our firm. We have previously referenced FICC's statement that the "Current Volatility Calculation did not respond effectively to the level of market volatility"[22] encountered during the fourth quarter of 2016. We also referenced basic data illustrating the fact that fourth quarter volatility wasn't unusually extreme. This is despite circumstances surrounding a political event that was judged by most to be "historic" in nature.[23] Is it possible there are other motivations driving the need for establishing the Margin Proxy as an additional VaR measure? We will explore these other possible motivations further in this comment letter, but first we want to point out major inconsistencies in this rule filing that present a specific competitive burden to our firm.

The original two-month GSD Var Charge Impact Study, which covers the fourth quarter period of 2016 that concerns the FICC, does not materially impact our contributions to the Required Fund Deposit. In other words, Ronin was already posting sufficient funds to the Required Fund Deposit according to FICC's Current Volatility Calculation during the fourth quarter of 2016. However, the year-long extended GSD VaR Charge Impact Study, that was provided at our request, clearly showed a material impact on our Required Fund Deposit during the first three quarters of 2016. Certainly, this appears to present an unfair competitive burden to our firm. The Margin Proxy Rule would require Ronin (and likely other similar-type Netting Members) to post additional margin during periods of time that don't concern the FICC. Given cost of capital differences among Netting Members, isn't it anti-competitive for the FICC to demand additional margin that is not needed? This point is particularly self-evident when the larger picture at Ronin is examined (scaled to protect proprietary data):

[22] SEC Release No. 34-79958 p. 4
[23] https://www.nytimes.com/2016/11/09/us/politics/hillary-clinton-donald-trump-president.html?_r=0

Extended Margin Proxy (13 months)	100.00 MM
Fourth Quarter Margin Proxy	83.00 MM
Current Volatility Calculation	82.09 MM
SEC Net Capital Rule (15c3-1)	49.72 MM
Internal VaR (99%)	3.46 MM

Some explanation of this data is clearly required. These numbers represent scaled averages. Averages are used to fairly compare with the VaR Impact Study provided by the FICC. We believe this data demonstrates the unfair competitive burden the Margin Proxy Rule imposes on our firm as described below.

For every 100MM of margin the FICC would require of Ronin under the Margin Proxy, other risk-related measures are provided as a means of comparison. The Margin Proxy requires Ronin to post significant additional margin, but not during the period of time that most concerns the FICC (the fourth quarter of 2016). Notably, the Margin Proxy requirement is double our Net Capital Rule requirements (SEC 15c3-1)[24] - an excellent Commission rule that has proven quite effective with respect to mitigating risk in U.S. Treasuries for many, many years. Finally, we have included our own scaled internal VaR (measured at 99%) to show how little actual default risk we truly present to the FICC. In other words, <u>Ronin is already posting 23 times our internal VaR to the FICC's Required Fund Deposit on average. Increasing that number to nearly 30 times our internal VaR accomplishes nothing for the FICC, other than adding to an unfair competitive burden.</u>

A Solution

As shown above, Ronin's internal VaR is extremely small when compared to our Required Fund Deposit obligations. This is because the Current Volatility Calculation only views our portfolio positions in isolation. The FICC does have a Cross-Margining Agreement[25] with the Chicago Mercantile Exchange ("CME"), but this agreement has not been kept up-to-date. Furthermore, despite providing margin relief on a daily basis, this Cross-Margining Agreement has no impact on intraday VaR calculations or historical back-testing. This is despite the fact that research shows that U.S. Treasury securities and interest rate futures are closely correlated to the millisecond.[26] We again point to the back-testing methodology as described by the FICC:

- Margin Portfolio values are calculated using the actual positions in such Netting Member's Margin Portfolio on a given day and the observed security price changes over the following three days. These back-testing results are reviewed as part of FICC's VaR model performance monitoring and assessment of the adequacy of each Netting Member's Required Fund Deposit.[27]

Despite a Cross-Margin Agreement with the CME, compliance with the mandate to ensure "back-testing coverage at a 99 percent confidence level"[28] is done in isolation. Given the CME and the FICC, as well as

[24] The SEC Net Capital Rule (Rule 15c3-1)
[25] Cross-Margining Agreement with the CME
[26] High-Frequency Cross-Market Trading in U.S. Treasury Markets
[27] SEC Release No. 34-79958 p. 4
[28] SEC Release No. 34-79958 p. 4

their respective memberships, are all incentivized to differentiate actual risks versus fantasy risks, aren't both clearing entities compelled to work with the Commission to develop a VaR methodology that is in the best interests of all? Is there value for the FICC and the CME to continue viewing risks in isolation, given the close correlations between U.S. Treasuries and interest rate futures? Given the effectiveness of the SEC Net Capital Rule (SEC 15c3-1) in resolving this inefficiency many years ago, we imagine the Commission could provide invaluable insight with respect to developing a VaR methodology that works for both U.S. Treasuries and interest rate futures in aggregate. The FICC already receives a nightly file from the CME containing the futures positions of Netting Members participating in the Cross-Margining Agreement. How difficult would it be to incorporate this information as part of FICC's back-testing process?

We know the FICC understands how to aggregate risks within a VaR framework that includes both U.S. Treasuries and interest rate futures. This was previously accomplished back in 2011, with approval from the Commission, when the FICC launched one-pot cross-margining as part of New York Portfolio Clearing (NYPC). The following statement was made by the FICC:

- The SEC approval permits FICC, for the first time ever, to participate in a cross margining arrangement that brings together fixed income cash and derivatives positions in a single margin calculation. This innovative one-pot model will produce significant capital efficiencies by margining the actual economic risk of combined portfolios of cash and derivatives positions. By offering a single combined view of risk across asset classes, one-pot margining also enhances market and regulatory transparency with respect to the clearing of fixed income portfolios, which can be used to identify and moderate systemic market risks, facilitating more orderly risk mitigation and reduction in settlement risks.[29]

Given it is extremely evident that the FICC understands how to margin a combined portfolio, it isn't clear what is holding the FICC back, other than a desire to do so.

Risks to Ronin

The Margin Proxy Rule will force Ronin to contribute more margin to the Required Fund Deposit. We believe this is anticompetitive. Unfortunately, loss mutualization ensures that Ronin also has greater possible risk of loss. If an extremely large Netting Member were to default, the fact that Ronin has more margin in the Required Fund Deposit also exposes our firm to greater risk. The FICC would likely state that this is appropriate, because this risk of loss is in "direct relation to the market risk presented by each Netting Member's Margin Portfolio." This is the same argument being used by the FICC for dismissing the unfair competitive burden associated with the implementation of the Margin Proxy.[30] And yet, as shown previously, this view of market risk is inaccurate because of the FICC's current inability to include interest rate futures, despite guidance from the Commission in the form of the SEC Net Capital Rule.

Returning to the issue of transparency, why did the increase in interest rates in the aftermath of the U.S. presidential election yield "back-testing deficiencies beyond FICC's risk tolerance."[31] Is the FICC

[29] NYPC Press Release
[30] SEC Release No. 34-79958 p. 12
[31] SEC Release No. 34-79958 p. 4

attempting to determine why? Is the simple fact that the FICC does not consider interest rate futures as a proper hedge for U.S. Treasuries the main reason for this back-testing failure? Is the FICC actually interested in developing a solution, or is this proposed rule merely a simple grab for margin? Does the FICC have other motivations that may be independent of developing an effective VaR model for U.S. Treasuries?

Motivation

It is difficult not to be suspicious that other motivations might be driving the FICC to push to accelerate the effectiveness of the Margin Proxy Rule. The first motivation is quite direct. The FICC recently received approval for a rule change which added the "Clearing Fund Maintenance Fee" to the GSD Rulebook. This fee is calculated in the following manner:

- The amount of the monthly Clearing Fund Maintenance Fee for a member will be calculated monthly, in arrears, as the product of 0.25% and the average of the member's actual cash deposit to the Clearing Fund as of the end of each day of the month, multiplied by the number of days in that month and divided by 360; provided that, the investment rate of return on investment by FICC of cash in the Clearing Fund for that month is equal to or greater than 0.25%.[32]

In other words, the FICC is charging a new fee of 25 basis points per year to Netting Members based on margin held in the Required Fund Deposit. When the FICC increases margin requirements, the fees for Netting Members increase. Not only does the Margin Proxy rule place a competitive burden on our firm, it also ensures that the FICC increases our fees.

As mentioned in the Ronin Letter, another motivating factor is the FICC's desire to collapse the separate rulebooks of the MBSD and the GSD into a single cohesive rulebook. Naturally, an important prerequisite of this effort involves synchronizing disparate VaR margin models. Given the Margin Proxy has already been approved as an "alternative volatility calculation"[33] for the MBSD, it seems likely that this is a small stepping stone towards merging the two divisions. Rather than working with the CME to resolve inefficiencies of the Cross-Margining Agreement, the FICC seems to be focused on prioritizing eventual cross-margin relief for a completely different asset class - mortgages. Without getting into specific details regarding the appropriateness of merging the MBSD and GSD under a single risk framework, doesn't it seem more reasonable to provide proper VaR offsets for a product that trades in a correlated fashion within milliseconds (interest rate futures), rather than focus on providing margin relief for an asset class that was largely responsible for the past financial crisis?

Finally, it seems strange that fourth quarter volatility isn't also forcing the CME to scramble to make a change in their VaR model. Perhaps working with the CME, under the guidance of the Commission, could enable the FICC to develop a better VaR model for mitigating risk of loss in U.S. Treasuries.

[32] SEC Release No. 34-78529 p. 4
[33] SEC Release No. 34-79491; p. 2

Conclusion

Ronin Capital believes that the GSD is critical for liquidity in the U.S. Treasury market. The U.S. Treasury market derives a large portion of its liquidity premium from its utility as a hedging instrument. Rule changes, which make it less economic for liquidity providers to run a hedged, market neutral book, could result in a decline in this liquidity premium - a premium estimated as high as 15%.[34] Since the U.S. Treasury market is the primary means of financing the U.S. federal government, this liquidity premium greatly benefits the U.S. taxpayer.

Unfortunately, declining volumes[35] within the FICC have led to increases in fees.[36] This reduces the value proposition of centralized clearing, despite other tangible benefits. Higher margin requirements might have an even worse effect on Netting Members. Increased fees and higher margin requirements will likely lead to further declines in volume - a vicious cycle.

We believe that there are clear flaws in FICC's VaR models and back-testing procedures. To obtain a 99 percent confidence level for all Netting Members, the FICC is certainly requiring much larger Required Fund Deposits than necessary for some Netting Members. Cost of capital differences among member firms will lead to uneven impact, which we believe is anticompetitive. Higher fees, increased margin requirements, and other coming rule filings (the Capped Contingency Liquidity Facility) affect our bottom line directly. Proprietary trading firms have no customers to pass these additional costs onto. Ronin believes the Margin Proxy Rule presents an unfair competitive burden, which ultimately will reduce liquidity while harming Netting Member diversity.

We believe the FICC should be transparent with their VaR models. This is particularly important, until technology is put in place to enable Netting Members to submit sample portfolios to conduct margin-based scenario analysis.

We believe the desire for harmonizing rules for mortgages and U.S. Treasuries may result in VaR models that might be inappropriate for margining U.S. Treasuries. Why does the FICC need to incorporate a completely new VaR model, when the SEC Net Capital Rule (15c3-1) has proven effective for many, many years?

Are the risks to the FICC so great that the Margin Proxy Rule needs to be approved and deployed in an abbreviated timeframe? Given a lack of transparency, as well as the potential for an unfair competitive burden, we respectfully request that the Commission deny the FICC's request to accelerate the effectiveness of this proposed rule change until:

1. The FICC can determine if the inclusion of futures positions would enable all (or most) Netting Members to achieve back-testing coverage at the 99 percent confidence level.
2. The FICC and the CME agree to develop, with guidance from the Commission, a Cross-Margining Agreement that could be incorporated within a VaR framework (similar to the SEC Net Capital Rule).

[34] https://www.newyorkfed.org/research/staff_reports/sr590.html pg. 25
[35] SEC Release No. 34-76840 p. 2
[36] SEC Release No. 34-78529

We thank the Commission for considering our comments. If you should have any questions, please contact me at [redacted] or [redacted].

Very truly yours,

Robert E. Pooler, Jr.
Chief Financial Officer,
Ronin Capital, LLC