January 18, 2019

U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549 United States
Attn: Mr. Brent J. Fields, Secretary

RE: FILE NUMBER SR-FICC-2018-013

Dear Mr. Fields:

Ronin Capital, LLC ("Ronin") appreciates the opportunity to comment on a proposed rule change by the Fixed Income Clearing Corporation ("FICC") to expand Sponsoring Member eligibility in the Government Securities Division ("GSD") Rulebook.[1] As stated by FICC, this proposed rule change is intended to "allow a broader group of Netting Members to participate in FICC as Sponsoring Members."[2] This rule change will also "allow a Sponsoring Member to establish a Sponsoring Member Omnibus Account that may contain transactions between a Sponsored Member and a Netting Member other than the Sponsoring Member."[3] Both of these rule changes are intended to expand access to centralized clearing within a risk framework that is designed to protect both the FICC and its membership. Because of the many benefits that greater liquidity in centralized clearing brings to the U.S. financial system, Ronin urges the U.S. Securities and Exchange Commission (the "Commission") to approve this rule modification.

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 ("FICC") and the Chicago Mercantile Exchange ("CME"). 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 "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.

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1 SEC Release No. 34-84951; File No. SR-FICC-2018-013
2 SEC Release No. 34-84951 p.1
3 SEC Release No. 34-84951 pp. 1-2

INTRODUCTION

In a 2015 speech given at the Clearing House Annual Conference, current Federal Reserve Chairman Jerome Powell stated:

> One area where market participants are actively searching for new business models is the repo market, where there are currently several private initiatives for greater central clearing. Expanded repo clearing could potentially bring a range of benefits, including greater opportunities for netting and related reductions in balance sheet costs for dealers affiliated with a bank holding company.[4]

Sponsored Membership is one of several attempts by the FICC to satisfy Chairman Powell's request for new clearing business models. Ronin believes that any business model with the potential to increase liquidity within centralized clearing is a worthwhile pursuit, provided that such business models neither discriminate against particular types of clearing members nor increase the risk to the CCP or its membership. Ronin is pleased that this rule change should enable more diversity among Sponsoring Members by expanding sponsorship capabilities beyond well-capitalized Bank Netting Members. As clarified by the FICC:

> As such, the proposed rule change would provide that Category 2 Sponsoring Member applicants could include, for example, Dealer Netting Members, Futures Commission Merchant Netting Members, and Foreign Netting Members.[5]

Ronin believes that this revision will help the FICC maximize the number of Netting Members willing to serve as Sponsoring Members. This revision, in turn, should result in an increase in the number of Sponsored Members, which should lead to an increase in volume being cleared at the FICC. This rule proposal also contains another important modification to Sponsored Membership as clarified by the FICC:

> FICC is proposing to allow a Sponsoring Member to establish a Sponsoring Member Omnibus Account that may contain transactions between a Sponsored Member and a Netting Member other than the Sponsoring Member...[6]

This rule modification is critically important because it enables Sponsored Member activity to reach beyond the explicit participation of the Sponsoring Member as a counterpart to every sponsored transaction. Ronin has a concern that activity within Sponsored Membership may be "sterilized" - meaning volume within centralized clearing will increase but visible liquidity in the U.S. Treasury repo market will not perceive any benefit.[7] While the risk of "sterilization" is not diminished, this critical rule modification opens up the opportunity for Sponsored Members to trade directly with other Netting Members, thus increasing liquidity provision. In summary, Ronin believes this rule change might improve liquidity in the U.S. Treasury repo market while also possibly reducing structural problems that exist today.

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[4] https://www.federalreserve.gov/newsevents/speech/powell20151117a.htm

[5] SEC Release No. 34-84951 p. 8

[6] SEC Release No. 34-84951 pp. 13-14

[7] The Sponsoring Member might limit sponsored access to situations where collateralized cash investors would be matched dollar for dollar with cash borrowers. The Sponsoring Member would enjoy balance sheet relief and increased income from this arrangement. However, liquidity in the visible U.S. Treasury repo market would not improve.

STRUCTURAL ISSUES AND LIQUIDITY CHALLENGES

Liquidity challenges seen at the end of 2018 provided a potent reminder that the U.S. Treasury repo market is still extremely dependent on bank intermediation to function properly. This structural dependence on bank intermediation can be disruptive when calendar-based regulatory constraints incentivize banks to dramatically reduce their participation in the repo market.[8] These structural issues at year-end were manifested in both an increased rate and greater dispersion in the Secured Overnight Financing Rate ("SOFR")[9] as measured by the Federal Reserve Bank of New York.

Secured Overnight Financing Rate

DATE	RATE (PERCENT)	PERCENTILES 1ST (PERCENT)	25TH (PERCENT)	75TH (PERCENT)	99TH (PERCENT)	VOLUME (US$BILLIONS)
2019-01-07	2.41	2.35	2.39	2.47	2.54	1,052
2019-01-04	2.45	2.30	2.43	2.51	2.60	1,041
2019-01-03	2.70	2.30	2.70	2.78	2.89	1,063
2019-01-02	3.15	2.30	3.10	3.29	3.70	1,092
2018-12-31	3.00	2.70	2.95	3.20	6.25	1,000
2018-12-28	2.46	2.30	2.45	2.54	2.60	927
2018-12-27	2.44	2.30	2.43	2.52	2.57	943
2018-12-26	2.44	2.30	2.43	2.52	2.57	957
2018-12-24	2.41	2.38	2.41	2.49	2.55	881
2018-12-21	2.40	2.35	2.39	2.47	2.54	927

While some cash borrowers were forced to pay a repo rate exceeding 6.25% as shown above, some cash investors were utilizing the overnight reverse repo program ("ON RRP")[10] and receiving the well-below market rate of 2.25%. Ronin believes it is apparent that bank intermediation is currently structurally required for collateralized cash investors to access the true prevailing market rate. When banks are forced to step back from this intermediation because of calendar-based constraints or funding stress, the structural fragility of the repo market prevents cash investors and cash borrowers from being able to transact. Solutions to this structural dependence are clearly needed. Ronin believes FICC's Sponsored Membership solution has the potential to help mitigate liquidity challenges faced by the repo market.

Yet, other challenges remain. The following chart shows the spread between the Tri-Party General Collateral Rate ("TGCR")[11] and the General Collateral Finance ("GCF") Rate.[12] Both of these components make up the Broad General Collateral Rate ("BGCR").[13]

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[8] Alex Harris, "Eye-Popping Surge in Repo Rate Blamed on Rules Instead of Funding Stress," Bloomberg, January 2, 2018.

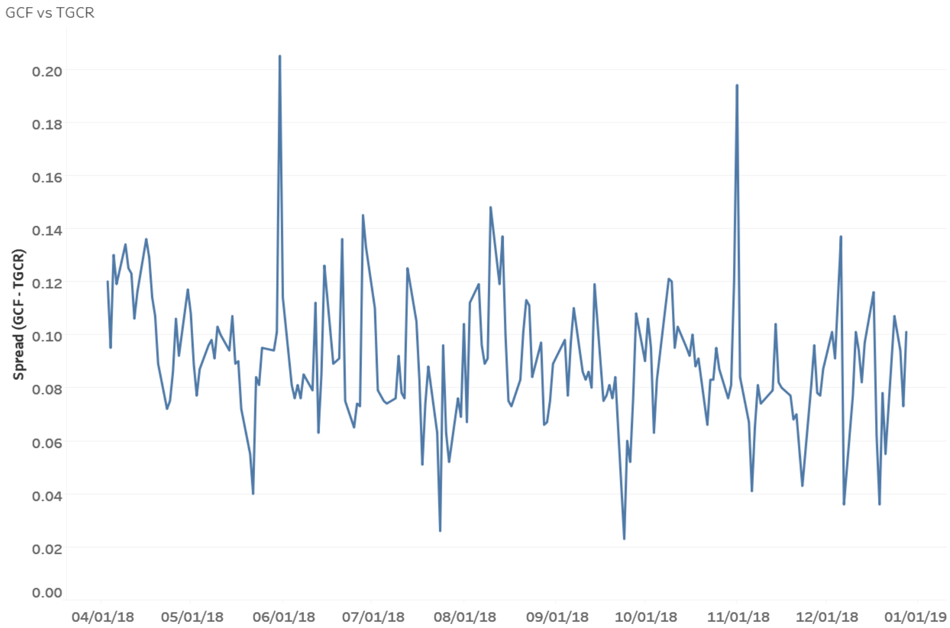
[9] See https://www.newyorkfed.org/markets/treasury-repo-reference-rates

[10] The overnight reverse repo program (ON RRP) is used to supplement the Federal Reserve's primary monetary policy tool, interest on excess reserves (IOER) for depository institutions, to help control short-term interest rates. See https://www.newyorkfed.org/markets/domestic-market-operations/monetary-policy-implementation/repo-reverse-repo-agreements

[11] See https://apps.newyorkfed.org/markets/autorates/tgcr

[12] Cleared through The Depository Trust & Clearing Corporation's GCF Repo service.

[13] See https://apps.newyorkfed.org/markets/autorates/bgcr



The median spread between these two rate measures is 8.8 bps.[14] This is somewhat surprising since this spread cannot be explained by credit-based concerns alone. GCF transactions are novated to the FICC, which has a higher credit rating than the banks that are participating in the Tri-Party repo market. Therefore, Ronin believes it is plausible that structural reasons explain this rate differential. Money Market Funds ("MMFs") and other cash investors are currently receiving a lower rate and facing worse credit because of structural inefficiencies in the repo market. Ronin is hopeful that Sponsored Membership can ease balance sheet restrictions on Sponsoring Members and consequently improve the resiliency of the repo market while possibly improving the collateralized rate paid to cash investors.

SPONSORED MEMBERSHIP SOLUTION

The FICC is proposing a potential solution to the structural issues and liquidity challenges mentioned in the previous section. The most beneficial aspect of Sponsored Membership relates to a potential reduction in balance sheet usage for the Sponsoring Member. This is particularly important for Bank Netting Members and their affiliates. As specified by the FICC:

> Sponsoring Members may be able to offset or otherwise reduce their balance sheets with respect to their obligations to FICC on Sponsored Member Trades, as well as take lesser capital charges that would be required to the extent they engaged in the same securities transactions with their Sponsored Members outside of a central counterparty.[15]

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[14] Data from 12/31/2018 was excluded merely for visualization purposes. The extreme spread on that day was 2.2% or 220 bps.
[15] SEC Release No. 34-84951 p. 14

These benefits will likely be passed on to Sponsored Members in the form of increased balance sheets. As stated by the FICC:

> By participating in FICC as Sponsored Members, eligible institutional firms may be afforded increased lending capacity and income because balance sheet and capital constraints on their Sponsoring Members may be alleviated.[16]

It is even possible with a reduction of balance sheets and capital constraints that the observed rate differential between transactions in Tri-Party versus transactions that are centrally cleared might decline. Such a decline would be easily detected by a decrease in the dispersion of the SOFR rate. Additionally, Ronin agrees that the growth of centralized clearing helps better safeguard the U.S. financial system. As pointed out by the FICC:

> FICC believes that the proposed rule changes to expand Sponsoring Member eligibility and the Sponsored Member Trade definition, as described above, would help to safeguard the U.S. financial market by lowering the risk of liquidity drain, protecting against fire sale risk, and decreasing settlement and operational risk.[17]

If approved, this rule change would allow a broader group of Netting Members to participate as Sponsoring Members. This should increase the number of Sponsored Members participating in centralized clearing and ultimately increase the size and number of transactions that are centrally cleared. Aside from the normal benefits attributed to centralized clearing, an increase in volume over time should help reduce costs. This cost reduction might result in making central clearing more affordable for a broader diversity of market participants.

AREAS OF CONCERN

It is rare that a rule proposal is perfect in intent and substance. Ronin has several concerns with the present form of Sponsored Membership. First, it is unclear how qualitative standards will be applied in terms of accepting new Category 2 Sponsoring Members or how such Category 2 Sponsoring Members will be monitored daily. As specified in the rule filing:

> However, since a Category 2 Sponsoring Member may have substantially less capital than a Category 1 Sponsoring Member, the proposed rule change would provide that FICC could impose financial requirements on an applicant to become a Category 2 Sponsoring Member that is greater than the financial requirements applicable to such applicant in its capacity as a Netting Member under Section 4(b) of Rule 2A.[18]

It is unfair to criticize the FICC for having qualitative standards, but unspecified requirements could be applied arbitrarily. The FICC certainly has a duty to protect all Netting Members from default risk. However, <u>history has shown that large amounts of capital are not necessarily correlated with safety</u>.

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[16] SEC Release No. 34-84951 p. 14
[17] SEC Release No. 34-84951 p. 15
[18] SEC Release No. 34-84951 p. 9

Ronin also has concerns about the ability of Netting Members that aren't affiliated with a bank to participate as Sponsoring Members due to VaR margin requirements. As stated by the FICC:

> Specifically, for purposes of calculating the Unadjusted GSD Margin Portfolio Amount for a Sponsoring Member Omnibus Account, each Sponsored Member's activity is assigned a separate VaR Charge, and, as such, the Unadjusted GSD Margin Portfolio Amount for the Sponsoring Member Omnibus Account is not reduced by any netting of positions as between different Sponsored Members within that Sponsoring Member Omnibus Account.[19]

Balance sheet usage is minimized, which is extremely beneficial for Bank Netting Members and their affiliates. However, the requirement that separate VaR charges are independently posted for each Sponsored Member will likely limit the ability of Netting Members that aren't affiliated with a bank to participate as a Sponsoring Member. It is unclear why the FICC needs to assign separate VaR charges for netted positions in the Sponsoring Member Omnibus Account. The netting process enables balance sheet reduction. <u>Balance sheet reduction is only possible through the netting of positions</u>. Assigning VaR charges for netted positions will likely limit wide adoption of Sponsored Membership to those Netting Members that have a low cost of capital.

Sponsored Membership also runs the risk of further promoting concentration risk if only widely adopted by the largest Netting Members. Despite balance sheet relief, Sponsored Member Trades still pose settlement risk. This is especially problematic if Sponsored Member activity increases the size of the Capped Contingency Liquidity Facility ("CCLF"). FICC clarifies the responsibility of the Sponsoring Member:

> In light of the fact that in all cases, a Sponsoring Member is in control of which securities transactions it submits for clearing on behalf of its Sponsored Members and, in turn, its related obligations to FICC with respect to the Clearing Fund, loss allocation, Capped Contingency Liquidity Facility® ("CCLF®"), the Sponsoring Member Guaranty, and fees....

There is a risk that Sponsored Membership might increase the CCLF responsibilities of other Netting Members if the liquidity needs of the largest Netting Members grow substantially. CCLF obligations are also more expensive for Netting Members that are not affiliated with banks. These Netting Members have higher costs of capital and therefore the CCLF significantly limits their ability to participate as Sponsoring Members. While Ronin Capital hopes to be approved as a Sponsoring Member, the CCLF will significantly limit the size of our participation.

ONE LAST CONCERN - STERILIZED LIQUIDITY OR WORSE

One last concern worth mentioning in greater detail is the prospect that increased volume is merely "sterilized" - market liquidity will not increase because Sponsoring Members will simply match up sponsored cash and collateral providers internally to take advantage of balance sheet relief. While Sponsored Membership could enable MMFs to participate competitively within centralized clearing, it isn't clear that such engagement will grow beyond "sterilized" participation.

[19] SEC Release No. 34-84951 p. 5

As explained earlier, the spread between the TGCR and GCF rates cannot be explained by credit differences. GCF trades novate to the FICC, which is a credit improvement compared to the bespoke bilateral risks that exist in the Tri-Party market. Other factors besides credit are clearly influencing this spread differential. It is possible that there is a supply and demand imbalance for collateralized cash in the inter-dealer market, which leads to higher rates than might be expected from credit considerations alone. Clearly, MMFs are receiving lower rates in the Tri-Party market than they could earn in the inter-dealer market. Ronin hopes that Sponsored Membership will enable MMFs to transact in the inter-dealer market in an "unsterilized" manner. Such participation by MMFs might collapse the spread between TGCR and GCF while bringing more liquidity into the inter-dealer market. Yet, there exists the possibility that Sponsored Access may serve as a vector for increasing the spread between TGCR and GCF as described below.

Prior to a 2017 rule change, Sponsored Members were limited to investment companies that were registered under the Investment Company Act of 1940 ("40 Act Funds").[20] This requirement ensured that Sponsored Members were cash investors. A rule change in 2017 waived the requirement that Sponsored Members were 40 Act Funds. Now, any qualified institutional buyer ("QIB") can become a Sponsored Member. This change enabled hedge funds and other leveraged entities to be sponsored for the first time. While pairing up these cash borrowers with MMFs and other cash investors increases "sterilized" volume within centralized clearing, there is a risk that sponsored cash borrowers might gain access to the inter-dealer market, further widening the spread between TGCR and GCF. A widening in this spread would harm existing Netting Members that are more reliant on the inter-dealer market for financing. Ultimately, Ronin assumes that the FICC will ensure that its Sponsoring Members are improving rather than degrading liquidity in the inter-dealer market.

Despite these concerns, Ronin still applauds the FICC for attempting to provide a potential solution for some of the structural inefficiencies that exist in the U.S. Treasury repo market. The fact that Sponsored Membership might degrade liquidity in the inter-dealer market does not mean that it will. There is certainly an opportunity for Sponsored Membership to improve liquidity and Ronin hopes this rule change will prove to be a critical vector for bringing efficiencies to the market. And there is always the opportunity for rule revision if this rule iteration does not achieve desirable results.

CONCLUSION

Through this rule change, the FICC is attempting to expand access to centralized clearing within a risk framework that is designed to protect both the FICC and its membership. Ronin believes this rule change has the potential to bring more liquidity into centralized clearing. However, there is also the possibility that Sponsored Membership might increase settlement risk if adoption is limited to only the largest Netting Members. Despite concerns regarding quality standards applied by FICC when approving new Sponsored Members, Ronin is optimistic that this rule change might increase the number of Sponsoring Members while also promoting diversity. We believe Sponsored Membership could help democratize access to clearing and promote healthy competition. Yet, there remains a risk that overall liquidity will not be enhanced if participation is merely "sterilized."

[20] See https://www.sec.gov/rules/sro/ficc/2017/34-80563.pdf

In conclusion, Ronin is pleased that the FICC is attempting to work on innovative solutions for expanding the use of centralized clearing in the U.S. Treasury repo market. In early 2016, Ronin responded to the Treasury Department's Request for Information ("RFI")[21] and stated the following:

> The fact that the FICC enables blind-brokered repo trading is quite important - and not just in the context of preventing "fire sale" risk. The FICC enables a "level playing field" for smaller and mid-sized firms, particularly for those firms that are not associated with a bank holding company (BHC). Such firms "consistently borrow cash (against securities) in this market." In this capacity, the FICC assumes the important role of a credit-facing intermediary, which enhances liquidity provision. Despite problems with equating credit ratings with default risk (Bear Stearns and Lehman Brothers are appropriate examples), many cash investors are more comfortable dealing with larger firms who generally have higher credit ratings than smaller firms. The FICC serves as an extremely important credit-facing intermediary in this capacity. In fact, it would probably be beneficial for the FICC to expand this role given the regulatory pressure on the G-SIBs.

Ronin optimistically thinks this rule change has the potential to enhance liquidity and grow centralized clearing. Therefore, despite several concerns, we urge the Commission to approve this rule change. We thank the Commission for considering our comments. If you should have any questions, please contact me by email at [redacted] or by telephone at [redacted].

Very truly yours,

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

[21] See Ronin RFI at https://www.treasurydirect.gov/instit/statreg/gsareg/RoninCapital.pdf p. 9

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