October 6, 2017

VIA ELECTRONIC SUBMISSION
(www.regulations.gov)

U.S. Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549
Attn: Mr. Eduardo Aleman, *Assistant Secretary*

RE: FILE NUMBER SR-FICC-2017-002

Dear Mr. Aleman:

Ronin Capital, LLC ("Ronin") appreciates the opportunity to further comment on a proposed rule change by the Fixed Income Clearing Corporation ("FICC") to modify the Government Securities Division ("GSD") Rulebook to implement the Capped Contingency Liquidity Facility ("CCLF"). On September 15, 2017, the U.S. Securities and Exchange Commission (the "Commission") requested additional commentary[1] on several specific items to help further inform its analysis of SR-FICC-2017-002 (the "Proposed Rule Change"). The intent of this response is to satisfy the Commission's request for additional information. For the sake of brevity, we will avoid reiterating in detail many of the anticompetitive arguments made in our two previous comment letters.[2] We continue to urge the Commission to reject FICC's proposed rule change in favor of developing a new and better liquidity plan.

In this letter, Ronin will respond to the various questions posed by the Commission on the following topics[3]:

- the Attestation Requirement,
- the value of the FICC's "liquidity funding report," and
- potential changes to trading behavior if the CCLF is approved.

ATTESTATION REQUIREMENT

The Proposed Rule Change has no clear compliance guidelines and is not enforced uniformly among Netting Members and, therefore, is unduly burdensome to comply with and discriminatory in its practice. The Proposed Rule Change would require each Netting Member to attest that its respective CCLF requirement (the "Individual Total Amount") has been incorporated into its liquidity plan. Unfortunately, without clear guidance from the FICC of what the uniform compliance requirements are for all Netting

[1] SEC Release No. 34-81638

[2] See letter from Robert E. Pooler Jr., Chief Financial Officer, Ronin, dated April 10, 2017, to Robert W. Errett, Deputy Secretary, Commission ("First Ronin Letter"); letter from Robert E. Pooler Jr., Chief Financial Officer, Ronin, dated June 19, 2017, to Robert W. Errett, Deputy Secretary, Commission ("Second Ronin Letter');

[3] SEC Release No. 34-81638 pp. 3-4

Members or how they will be enforced, we are unable to effectively plan to comply with regulators. When we request clear and transparent compliance requirements in order to comply with the Attestation Requirement, the FICC answers that it is strictly "between us and our regulators." We are not implying that the FICC is purposefully refusing to divulge information. The FICC really doesn't know how regulators will interpret compliance with the CCLF. This lack of clarity and the fact that the Commission is asking the Netting Membership how compliance with the Proposed Rule Change will be attested to, leads us to question how this rule passes the "non-discriminatory" standard required for complying with the Exchange Act. FICC has made an effort to come up with a cost-effective means of helping smaller Netting Members comply with the requirements of the CCLF, however; it is still unknown whether this method of compliance will actually be accepted by regulators.

A recent ruling by the D.C. Circuit of the United States Court of Appeals in *Susquehanna Int'l Group, et al v. SEC* (the "Garland Ruling")[4] stated that rules should not be "designed to permit unfair discrimination... among participants in the use of the clearing agency."[5] Without uniform compliance requirements, there arises the real possibility that differences in regulatory oversight could have a discriminatory impact. Smaller Netting Members will be forced to contract with an external entity to obtain a committed line of credit with no assurances of obtaining a line of credit in the future or of how the terms of the line of credit may change. Not knowing if that line of credit will be available or at what cost creates burdensome uncertainty in planning a business. Larger Netting Members do not have to incur these costs and can just footnote this liability as part of their liquidity plan. This difference in enforcement is discriminatory to the smaller Netting Members. Additionally, it is discriminatory that some Netting Members are regulated by the Board of Governors of the Federal Reserve while other Netting Members are regulated by FINRA. Regulatory compliance will likely be applied and enforced differently when two different organizations are interpreting and enforcing rules without a cohesive and centralized governing authority.

Ultimately, Ronin believes the Attestation Requirement is anticompetitive. From a transparency perspective, it is not ideal when a self-regulatory organization ("SRO") and that same SRO's regulator do not know how or if members of that SRO will be able to comply with a rule change. The FICC has a lot of flexibility in the manner by which it can comply with the Exchange Act. We believe the main reason the CCLF was proposed as the "liquidity plan" for the GSD was simply out of convenience - a similar liquidity plan was approved for the Mortgage-Backed Securities Division ("MBSD"). Given the Proposed Rule Change has the potential to force smaller firms to give up their GSD membership, we believe it is discriminatory for the FICC to propose such a rule out of expediency or in an effort to harmonize rules between the two divisions of FICC. Mortgage-backed securities ("MBS") and U.S. Treasuries have different risk profiles, especially during a crisis. We don't believe they should share the same liquidity plan.

VALUE OF THE DAILY "LIQUIDITY FUNDING REPORT"

Ronin believes there is very limited value in the daily "liquidity funding report" that the FICC proposes to distribute to its Netting Members. We have not received an example of this report yet, but we believe this report will only pertain to our own settlement activity. This information is not particularly useful, because any potential liability is not based solely on our own activity but on the peak liquidity need generated by the default of the largest participant ("Cover 1").[6] We cannot determine liability when we only see our own activity and not the obligations of other Members. Each Netting Member's "fair share" of FICC's liquidity need is based on a ratio of an observable number and an unobservable number. The unobservable number, the "denominator," is FICC's total liquidity need, which is determined by the liquidity need of the largest participant family, which is not disclosed. Even if this number were to be disclosed, it can change

[4] https://www.gpo.gov/fdsys/pkg/USCOURTS-caDC-16-01061/pdf/USCOURTS-caDC-16-01061-0.pdf

[5] Garland Ruling p. 6

[6] SEC Release No.34-80234; File No. SR-FICC-2017-002 p. 23

significantly over time.[7] In effect, the Proposed Rule Change asks each Netting Member to take on an unknown liability. Receiving a report that details this liability after the fact is not helpful from a planning perspective. <u>We cannot manage the risk of a liability after it is incurred</u>. Therefore, this daily liquidity funding report provides little value because it cannot predict the future settlement obligations of the largest Netting Members.

BEHAVIORAL CHANGES

The Cover 1 Requirement is quite likely to grow dramatically during crisis conditions. The belief that the largest Netting Members can change their behavior and thus reduce the Cover 1 Requirement has not been shown to be true during crisis conditions. The FICC conducted a test from December 1, 2016 to January 31, 2017 where 35 Netting Members voluntarily adjusted their settlement behavior and settlement patterns to identify opportunities to reduce their CCLF requirements. FICC's peak Cover 1 Requirement was reduced by approximately $5 billion, highlighting that there is an opportunity for Netting Members to take steps to limit the growth of the Cover 1 requirement.[8] While it is commendable that the FICC conducted such a test, this test was conducted during a period of time that certainly was far removed from crisis conditions. We believe this test misrepresents the likelihood for this same behavior to produce the same results during crisis conditions. Rather, we believe the Cover 1 Requirement will likely grow dramatically during any future financial crisis as Netting Members are forced to shift to a dependence on overnight financing. Research seems to back this view:

- As the financial crisis progressed, funding markets came under unprecedented stress; liquidity and counter-party concerns led many money market participants to seek out Treasury securities, and term funding became scarce.[9]
- An analysis of primary dealer behavior (using data from the Federal Reserve Bank of New York) during the Financial Crisis showed a shift from term to overnight financing during the crisis - a ratio of overnight to term financing increasing from 1.5 times to a peak of around 3.5 times - for Treasury, mortgage, and government-sponsored agency bonds.[10]

The behavioral change that enables Netting Members to reduce the Cover 1 Requirement becomes quite limited during periods of extreme financial stress. This exposes Netting Members to an unknown liability that might actually discourage the provision of liquidity, at a time when this liquidity is most needed.

REDUCTION IN MARKET PARTICIPATION

Smaller Netting Members are being economically punished by these regulatory changes, despite not receiving nor needing support during the Financial Crisis. The cost of satisfying the requirements of the CCLF may force some Small Netting Members to withdraw from the GSD.

As stated in the previous letters, a reduction in market participation reduces liquidity and competition. This is certainly not beneficial for the U.S. Treasury market in normal conditions, much less crisis conditions. GSD Netting Member diversity proved valuable during the Financial Crisis. Turning the GSD into a "club" for the large money center banks will certainly not benefit the market in any future financial crisis.

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[7] https://www.wsj.com/articles/cost-of-repo-safety-net-hits-74-billion-1490014800

[8] letter from Timothy J. Cuddihy, Managing Director, FICC, dated April 25, 2017, to Robert W. Errett, Deputy Secretary, Commission ("FICC Comment Letter") p. 9

[9] Hrung, Warren and Jason Seligman. 2011. "Responses to the Financial Crisis, Treasury Debt, and the Impact on Short-Term Money Markets." Federal Reserve Bank of New York Staff Reports, no. 481, p. 5

[10] Krishnamurthy, Arvind. 2009. "How Debt Markets Have Malfunctioned in the Crisis." National Bureau of Economic Research, Working Paper 15542, p. 15

The economics associated with clearing U.S. Treasuries within the GSD have deteriorated. Fees and margin requirements associated with trading within the GSD have increased significantly. The CCLF is only the latest in a long line of changes enacted since the Financial Crisis that have reduced the return characteristics of trading U.S. Treasuries for members of the GSD. Some examples include:

- Intraday margin calls[11]
- TMPG Fails Charges[12]
- Increased costs associated with Daylight Overdraft
- Fees tied to margin (the "Clearing Fund Maintenance Fee")[13]
- Increases in margin (the "Margin Proxy")[14]
- The CCLF

These regulatory changes add significant additional costs to clearing U.S. Treasuries. Degrading economics certainly encourage a reduction in market participation. The CCLF will only contribute to this trend.

The idea that "smarter behavior" could eliminate or reduce some of these cost increases is simply not true. Both intraday margin calls and TMPG Fails charges are dependent on the settlement process - a process which is largely outside of a Netting Member's control. For example, if a Netting Member owns a 10Y note and finances it via overnight repo, the Netting Member is reliant on the FICC to return that 10Y note in order to avoid TMPG Fails charges. Additionally, if the FICC does not return the 10Y note by mid-day, the Netting Member is charged additional intraday margin merely for financing that same security in the morning. The act of financing a position within the FICC exposes a Netting Member to TMPG fails charges as well as to additional intraday margin. And this is simply because the FICC is unable to return a given security to a Netting Member by mid-day, or not at all. This is not the FICC's fault. These settlement inefficiencies are merely a side effect of the netting process. However, the Netting Member is generally powerless to improve the chances of a better outcome other than to simply reduce market participation.

Finally, as we've pointed out before, it is difficult to criticize a CCP for increasing the amount of margin required of Netting Members. More margin is associated with greater safety, and the possible negative consequences to market participation and liquidity always seem to be a secondary concern. However, the FICC has tied a significant component of its fee base to the margin charged to its Netting Members. The "Clearing Fund Maintenance Fee" gives the FICC an awkward incentive to increase margin simply because it increases its fee base.

REGULATIONS SHOULD NOT BE ARBITRARY AND CAPRICIOUS

The Garland Ruling also talks about the "arbitrary and capricious" standard, "the agency must examine the relevant data and articulate a satisfactory explanation for its action including a 'rational connection between the facts found and the choice made.'"[15] Regulation should not include preparing for implausible scenarios but should be based on the relevant data and historical facts.

As mentioned in the Second Ronin Letter, we question the "extreme, but plausible" set of preconditions underlying the need for the CCLF.[16] The presumption that the Proposed Rule Change is needed because the

[11] see GSD Rulebook, Rule 4, Section 2A

[12] TMPG Fails Charges F.A.Q

[13] SEC Release No. 34-78529; File No. SR-FICC-2016-004

[14] SEC Release No. 34-79958; File No. SR-FICC-2017-001

15 Garland Ruling p. 5

16 Second Ronin Letter p. 4

FICC will be unable to act on its own behalf is implausible based on the historical record. U.S. Treasury collateral has always been in incredible demand during any previous crises. The historical evidence supporting this conclusion is overwhelming.

Based on this historical evidence, it is implausible that the FICC will be unable to act on its own behalf. The first set of supporting commentary comes from the Federal Reserve Bank of St. Louis:[17]

- Nonetheless, the collapse of Lehman Brothers on Sept. 15, 2008, signaled the beginning of a financial panic. Increased selling pressure by panic-stricken investors lowered prices and raised yields on corporate bonds. At the same time, investors increased their demand for safer assets, namely U.S. Treasuries, and this led to a further decline in the yields on U.S. Treasuries.
- The uncertainty in the mortgage market also encouraged investors to switch from other debt instruments, such as mortgage-backed securities, into government securities.

We have a crisis. U.S. Treasuries are in demand. And yet, we need to presume any U.S. Treasuries held by the FICC are not in demand. The Federal Reserve Bank of St. Louis goes on to describe some anomalous behavior associated with U.S. Treasuries during the Financial Crisis. U.S. Treasuries were in such demand that prices continued to increase despite an increasing supply:

- In summary, there has been a large expansion in the amount of Treasury security offerings while yields on Treasuries have actually declined. Stated differently, the prices on Treasury securities have actually increased in the face of a rapidly expanding supply of these securities. This anomalous behavior in the market for Treasuries can be explained by a significant increase in the demand for Treasuries—"the flight to safety" in the event of a financial crisis.

The Federal Reserve Bank of New York supports this same conclusion - steps were even taken to increase the amount of U.S. Treasury collateral available due to the incredible demand for this safest of asset classes:[18]

- We find that the Term Securities Lending Facility (“TSLF”), which was introduced specifically to address stresses in short-term funding markets, was effective in alleviating the dislocations due to the increased demand for Treasury collateral as the crisis progressed.

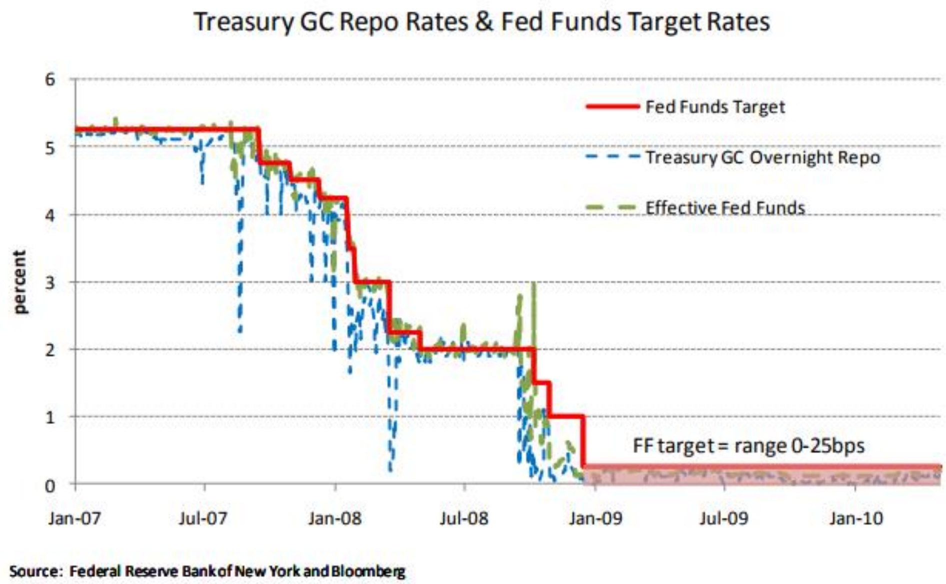
A crisis results in a predictable response - the flight to quality and liquidity. The Federal Reserve Bank of New York further comments:

- Treasury overnight GC was in high demand causing its rates to plunge and the spread between the fed funds target rate and Treasury GC repo rates (as well as the spread between repo rates for other collateral such as Agency debt and Treasury GC repo rates) widened to extraordinary levels as part of a flight to liquidity

17 Noeth, Bryan and Sengupta, Rajdeep. 2010. “Flight to Safety and U.S. Treasury Securities”, Federal Reserve Bank of St. Louis

18 Hrung, Warren and Seligman, Jason. 2011. “Responses to the Financial Crisis, Treasury Debt, and the Impact on Short-Term Money Markets.” Federal Reserve Bank of New York Staff Reports, no. 481

The demand for Treasury collateral was so pressing that Treasury general collateral ("GC") repo rates traded significantly through Fed Funds:



To conclude, without diminishing the difficult challenge facing our regulators as they try to protect the United States from the next financial crisis, there is no limit to the extreme hypothetical scenarios that could be considered. Boundaries are needed with respect to the extreme scenarios that can be contemplated – particularly when those scenarios require regulator intervention and protection. This is particularly true when there is overwhelming historical data available contradicting the need to prepare for a completely hypothetical set of conditions.

MOVE TO BILATERAL SETTLEMENT

The CCLF along with increased fees and diminishing returns associated with clearing U.S. Treasuries are forcing members to engage in more trading activity through bilateral settlement instead of centralized clearing. Centralized clearing is preferable to bilateral settlement in that it increases activity and reduces risk. Such benefits mean very little once the economics of trading U.S. Treasuries degrade to such an extent that it becomes very difficult to generate a return on a standalone basis.[19] We have already seen one particular trading strategy, high frequency trading ("HFT"), where the high costs associated with centralized clearing have resulted in a move towards bilateral settlement. It is not a positive trend that further cost increases run the risk of pushing more volume away from centralized clearing and the FICC.

Shifting the burden of the CCLF from the Small Netting Members to the Netting Members who are causing the problem, would keep more trading activity centralized, reduce risk, and create a fair non-discriminatory regulatory environment. It is unfair that the CCLF imposes a significant and potentially unknown liability on Smaller Netting Members, in order to ensure that the FICC is protected from the largest Netting Members (i.e. by meeting the Cover 1 standard). Smaller Netting Members are forced to lessen the economic burden of subsidizing the liability of the CCLF by moving volume into bilateral settlement. Regulation enacted since the Financial Crisis has in many ways undermined the economic competitiveness of centralized

[19] U.S. Treasuries are a potent hedge for interest rate risk. It is possible some Netting Members view the product as a loss leader because of the tremendous profit associated with trading riskier products.

clearing, at least for some types of market participants. Haircut levels in the bilateral market are simply based on the creditworthiness of the counterparty and the credit quality of the collateral.

FINAL COMMENT

The Attestation Requirement has no clear compliance guidelines and is not enforced uniformly. The cost of complying with these regulations through obtaining lines of credit are disproportionately burdensome on the Small Netting Members, forcing some out of the market entirely. This reduction in market participation leads to less liquidity, competition and diversity among Netting Members which is detrimental to the U.S. Treasury market under any conditions, especially times of a financial crisis. A liquidity plan (the CCLF) originally designed to support the MBSD does not make sense for the GSD because the instrument classes clearly behave differently. FICC should shift the burden of the CCLF from the Small Netting Members to the Netting Members who are causing the problem. This would keep more trading activity centralized, reduce risk, and create a fair non-discriminatory regulatory environment.

In conclusion, we request that the Commission reject FICC's proposed rule change in favor of developing a new and better liquidity plan. We thank the Commission for considering our comments. If you should have any questions, please contact me via email at [redacted] or via telephone at [redacted].

Very truly yours,

Robert E Pooler Jr.
Chief Financial Officer
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Other signatories on this comment letter:

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