April 7, 2017

Robert W. Errett
Deputy Secretary
Securities and Exchange Commission,
100 F Street, NE
Washington, DC 20549

RE: FILE NUMBER SR-FICC-2017-003

Dear Mr. Errett:

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 expand the types of entities that are eligible to participate in the FICC as Sponsored Members.[1] As more fully described below, given the significant risks and anticompetitive aspects associated with FICC's requested rule modification, Ronin strongly urges the Securities and Exchange Commission (the "Commission") to reject such modification.

By way of background, the FICC previously established the Sponsored Membership program to enable well-capitalized Bank Netting Members to sponsor registered Investment Companies.[2] Under the proposed rule modification, while the requirements of Sponsoring Members remain intact, the requirements for Sponsored Members are greatly relaxed. Instead of requiring that a Sponsored Member be a registered Investment Company under the Investment Company Act of 1940, the proposed rule modification would merely require that a Sponsored Member be a "qualified institutional buyer" as defined by Rule 144A under the Securities Act of 1933.[3]

The FICC advocates for this expansion because it would grow centralized clearing. An expansion of the Sponsored Membership program would bring the benefits of FICC's "independent risk management and guaranty of completion of settlement"[4] to these newly sponsored entities. Sponsoring Members (i.e. large Bank Netting Members) would also benefit from potential "offsets on their balance sheets" as well as "lesser capital charges."[5] The FICC also makes the claim that "the proposed expansion of entity types eligible to participate in FICC as Sponsored Members 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."[6]

Ronin agrees with some of these statements. We are fully supportive of the expansion of centralized clearing. However, we believe expanding centralized clearing in this particular manner promotes increased concentration and settlement risk and also places an unfair competitive burden on non-bank Netting Members. Undoubtedly, this proposed rule modification dramatically changes the character of the Sponsored Membership program that was originally approved by the Securities and Exchange Commission (the "Commission") back in 2005. While relaxing the standards of the Sponsored Membership program to allow entities like insurance companies and employee benefit plans to access the FICC may seem relatively benign,

[1] SEC Release No. 34-80236; File No. SR-FICC-2017-003
[2] SEC Release No. 34-51659; File No. SR-FICC-2004-22
[3] SEC Release No. 34-80236 p. 5
[4] SEC Release No. 34-80236 pp. 4-5
[5] SEC Release No. 34-80236 p. 5
[6] SEC Release No. 34-80236 p. 7

the modification would also enable hedge funds and other highly leveraged entities to be sponsored by a Bank Netting Member. This is something entirely different. The FICC is transparent about the current use of the Sponsored Membership Program:

> The Sponsoring Member-Sponsored Member relationship has historically been based on a custodial banking arrangement in which the Sponsored Member Trades novated to FICC reflect investments by the Sponsoring Member of a registered Investment Company Sponsored Member's cash through Repo Transactions.[7]

So historically, the Sponsored Membership program facilitated cash investing by unleveraged registered Investment Companies. This is very different conceptually from facilitating access by a hedge fund that is using the FICC to obtain leverage. Indeed, such a significant change in character of the Sponsored Membership program should necessitate a new rule filing rather than just a seemingly simple rules modification. The FICC explains why entity type expansion is appropriate:

> FICC believes that expanding eligibility to become a Sponsored Member beyond registered Investment Companies under the Investment Company Act of 1940 is appropriate because FICC's risk management of the Sponsoring Member-Sponsored Member relationship occurs primarily at the Sponsoring Member level, and the proposed expansion of the entity types eligible to participate in FICC as Sponsored Members (and the commensurate potential volume increase in novated activity) would not require any changes to FICC's risk management practices applicable to Sponsoring Members or to FICC's operational practices applicable to the comparison, novation, netting and settlement of Sponsored Member Trades.[8]

This rule change enables leveraged hedge funds to be sponsored, and yet, expanding the Sponsored Membership program "would not require any changes to FICC's risk management practices." Given all Netting Members must contribute to loss mutualization, the rule modification would only increase risk and add a competitive burden.

Ronin is concerned the anticompetitive aspects and other risks associated with this rule proposal have not been fully considered. These include:

1) The largest Bank Netting Members will likely incur more settlement risk by acting as Sponsoring Members. This will increase the proposed CCLF requirement for all Netting Members.[9]
2) New types of Sponsored Members, especially hedge funds and other highly leveraged entities, contribute asymmetrical risk to the FICC without participating in loss mutualization. These risk-taking entities reap the benefits of centralized clearing without fully contributing to the costs.
3) Concentration risk will increase. Instead of promoting Netting Member diversity, the Sponsored Member program only creates greater dependency on the largest global banks.
4) An increased dependence on the largest global banks could turn the FICC into a vector of systemic risk during a crisis. Default by a Sponsoring Member would prove problematic for Sponsored Members.

Consequently, Ronin respectfully asks the Securities and Exchange Commission (the "Commission") to reject approval of this requested modification to the Sponsored Membership program. We believe centralized clearing should be expanded, but not through a plan that only benefits Bank Netting Members and allows Sponsored Members to circumvent loss mutualization and avoid participation in the CCLF. Alternatively, we are supportive of a change that would expand sponsored access to cash investing entities only, because this

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[7] SEC Release No. 34-80236 p. 5
[8] SEC Release No. 34-80236 pp. 6-7

[9] A rule proposal (SR-FICC-2017-002) that would implement the Capped Contingency Liquidity Facility ("CCLF") was filed with the Commission on March 14, 2017.

would not significantly alter the character of the Sponsored Membership program. The rest of this comment letter further details the anticompetitive impact of this proposed rule modification as currently written.

Asymmetric Impact

Ronin believes the amended Sponsored Membership program, as proposed, creates winners and losers. The FICC claims this proposed change would only "promote competition by increasing the types of entities that may participate in FICC as Sponsored Members and therefore permit more market participants to utilize FICC's services."[10] There is no mention of any increased burden on competition for existing GSD Members. Despite this lack of mention, Ronin believes the proposed modification of the Sponsored Membership program creates clear winners and losers.

Winners: Bank Netting Members, Sponsored Hedge Funds

Bank Netting Members, particularly those that offer prime brokerage services, benefit the most from this new Sponsored Membership program. The FICC is transparent about this opportunity:

> In addition, Sponsoring Members also may be able to offset on their balance sheets their obligations to FICC on Sponsored Member Trades against their obligations to FICC on other eligible FICC-cleared activity, as well as take lesser capital charges than would be required to the extent they engaged in the same trading activity with their Sponsored Members outside of a central counterparty. By potentially alleviating balance sheet and capital constraints on their Sponsoring Members, participation in FICC as Sponsored Members may afford eligible institutional firms increased lending capacity and income.[11]

In our opinion, this is the main purpose of this proposed rule modification - alleviating balance sheet constraints and capital charges for Bank Netting Members. Sponsoring Members (prime brokers) can take advantage of netting capabilities while charging fees to Sponsored Members (hedge funds). <u>Reduced capital charges lead to increased lending capacity (i.e. leverage) made available for the Sponsored Member.</u> This seems like a great plan for increasing volume within the FICC, but there is a catch. Netting within the FICC increases capital efficiency. Ultimately, this will lead to more leverage, when compared to activity that was previously done outside of the central counterparty. Do leverage ratio constraints disappear when transactions are moved inside a central counterparty and netted? This increased leverage does not come without fat tail risk - it comes in the form of the Sponsoring Member guaranty.

The Guaranty

As mentioned previously, this proposed rule change "would not require any changes to FICC's risk management practices." The FICC relies on the Sponsoring Member to manage the default risk of the Sponsored Member. As stated:

> in the event one or more Sponsored Members does not satisfy its settlement obligations, FICC is able to invoke the guaranty provided by the Sponsoring Member.[12]

Simply stated, if a Sponsored Member defaulted, the Sponsoring Member is responsible for this default as part of the guaranty. We speculate that this default risk isn't accounted for by regulators. As mentioned previously, netting within the FICC provides balance sheet offsets and reduced capital charges for Sponsoring Members. We suspect default risk that might be transmitted by a Sponsored Member isn't measured or accounted for. <u>The default of a sponsored hedge fund or several sponsored hedge funds could potentially threaten the Sponsoring Member or even the FICC. Also, the guaranty of a Sponsoring Member could actually present risk of loss to other Netting Members because of loss mutualization.</u> To be fair, the chance that a really large hedge

[10] SEC Release No. 34-80236 p. 16
[11] SEC Release No. 34-80236 p. 5
[12] SEC Release No. 34-80236 p. 7

fund would suffer losses large enough to threaten the FICC seems remote. However, other Netting Members are certainly not being compensated for this fat tail risk. Is this risk easily ignored, or does it present a competitive burden?

Losers: Other Netting Members

Generally when there are winners, there are also losers. Losing in this instance comes in the form of an unfair competitive burden. In our opinion, Netting Members that are not participating as Sponsoring Members - either because of choice or ineligibility - are negatively impacted by this rule modification proposal. These Netting Members that aren't participating in the Sponsored Membership program ("non-Sponsoring Members") bear added costs and risks associated with the Sponsored Membership program without being compensated. These non-Sponsoring Members don't receive balance sheet offsets or reduced capital charges. They also lose out on fee income and the ability to provide additional lending capacity to their clients. This is merely because these non-Sponsoring Members don't happen to be Bank Netting Members. Unfortunately, despite the inability to participate in this program, there are still risks to absorb and costs to pay as described below.

The CCLF

The CCLF is a proposed rule awaiting approval by the Commission intended to ensure that the FICC has sufficient financial resources "to meet its cash settlement obligations in the event of a default of the largest family of affiliated Netting Members."[13] If such a default exceeded liquid resources available to the FICC, additional financial resources would be provided by its non-defaulting Netting Members.

One of the major benefits of novating trading activity to the FICC is "guaranty of completion of settlement."[14] The CCLF is intended to ensure that cash settlement obligations are met, even if the largest Netting Member were to default. The CCLF, as currently proposed, comes with a cost that all Netting Members are forced to bear. Why should leveraged hedge funds, as Sponsored Members, receive this benefit for free?

Ronin also believes the Sponsored Membership program, in its proposed expanded form, will increase the "Cover 1" requirement that the size of the CCLF is based on. The largest global banks, as Bank Netting Members, can generate fee income from Sponsored Members. But an increase in the CCLF requirement impacts all Netting Members. We believe this creates a moral hazard. The largest global banks capture fees by extending leverage through the Sponsored Membership program. Other Netting Members are forced to cover the costs of this increase in risk due to the CCLF requirement. Isn't this an unfair competitive burden?

Loss Mutualization

This rule proposal expands the types of entities that are eligible to participate in the FICC as Sponsored Members. This expansion includes hedge funds and other entities that employ leverage. And yet:

> Sponsored Members shall not be obligated for allocations, pursuant to Rule 4, of loss or liability incurred by the Corporation.[15]

Sponsored Members don't participate in loss mutualization. Sponsored Members enjoy the benefits of centralized clearing without bearing any costs associated with loss mutualization. We believe this is clearly anticompetitive.

The Sponsored Membership program in effect today only enables registered Investment Companies to participate as Sponsored Members. These entities don't impart any risk to the FICC or other Netting Members

[13] SEC Release No. 34-80234 p. 2
[14] SEC Release No. 34-80236 p. 5
[15] SEC Release No. 34-80236 Exhibit 5 Section 12

because they only invest cash. Thus, waiving participation in loss mutualization seems entirely reasonable. In our opinion, waiving loss mutualization for leveraged hedge funds presents an unfair competitive burden on Netting Members that are unable to participate in the Sponsored Membership program.

Fire Sales

The FICC claims the expansion of the Sponsored Membership program reduces liquidity drain and fire sale risk:

> Expanding the types of institutional firms that are eligible to participate in FICC as Sponsored Members and thereby benefit from FICC's guaranty of completion of settlement of their eligible transactions would mitigate the risk of a large scale exit by such firms from the U.S. financial market in a stress scenario and therefore lower the risk of a liquidity drain in such a scenario. Specifically, to the extent institutional firms would otherwise be engaging in the same type of eligible trading activity (e.g., repurchase agreement transactions) outside of a central counterparty, having such activity novated to FICC and subject to FICC's guaranty of completion of settlement would reduce the risk that such institutional firms discontinue such trading activity in a Netting Member default situation.[16]

Sponsored Members are dependent on their Sponsoring Member. If the Sponsoring Member went into default, there is still a dependency regardless of whether or not trading activity is inside or outside of the central counterparty. We believe enthusiasm regarding the prevention of "liquidity drain" through Sponsored Membership should be subdued, because netting inside the FICC will likely lead to more leverage. Doesn't an increase in leverage increase the risk of liquidity drain if a Sponsoring Member were to default?

The FICC states further:

> Similarly, broadening the pool of entities eligible for central clearing at FICC as Sponsored Members would also reduce the potential for market disruption from fire sales. Specifically, in a Netting Member default situation, the more institutional firms participate in FICC as Sponsored Members, the more trading activity with the defaulted Netting Member could be centrally liquidated in an orderly manner by FICC rather than by individual counterparties in potential fire sale conditions.[17]

This statement presumes that the defaulting Netting Member is not participating in the Sponsored Membership program. What does a hedge fund do if their Sponsoring Member defaults? Access to the FICC is only granted through the Sponsored Membership program.

If the beneficial motivating factor for approving this rule proposal is the reduction of fire sale risk, we can only comment that there are better alternatives that don't present a competitive burden or promote concentration risk. The Sponsored Membership program will likely create a dependency on the largest global banks. If these Bank Netting Members were to experience stress in a correlated manner, as shown during the last financial crisis, dependencies on Sponsoring Members would prove debilitating. Isn't the U.S. Financial System betting served by adding independent clearing members versus entrenching a dependency on the largest global banks?

Conclusion

Ronin believes this proposed rule dramatically changes the character of the Sponsored Membership program that was originally approved by the Securities and Exchange Commission (the "Commission") back in 2005. Sponsored Members, including sponsored hedge funds, would reap the benefits of centralized clearing without paying the costs. Sponsored Members do not participate in loss mutualization. They will not be contributing to

[16] SEC Release No. 34-80236 pp. 7-8
[17] SEC Release No. 34-80236 p. 8

the CCLF. These Sponsored Members impart risk to other GSD Netting Members without participating in risk mitigation. We believe this is anticompetitive. In addition, the benefits of the Sponsored Membership program for sponsors - balance sheet offsets and lower capital charges - are only afforded to Bank Netting Members. Yet, all Netting Members are required to bear the additional risks associated with the expansion of this program. Again, we believe this is anticompetitive.

Ronin fears this rule proposal will only serve to promote concentration risk and a dependency on our largest global banks. Is the FICC trying to create a small tier of large global banks that control access to clearing in the U.S. Treasury market? Isn't a large diverse GSD membership safer for the U.S. financial system when compared with encouraging a dependency on a small concentrated group? Shouldn't full Netting Membership be expanded rather than increasing concentration risk?

The end should not justify the means. Expanding centralized clearing is a worthwhile objective. However, we believe it is an unfair competitive burden to make all Netting Members bear the risks of this expansion, while only a few derive the benefits. Hedge funds and other highly leveraged entities will reap the rewards of centralized clearing without bearing the full costs. We believe this is anticompetitive.

Given an unfair competitive burden, Ronin respectfully requests that the Commission deny the FICC's request to modify the GSD Rulebook to expand the types of entities that are eligible to participate in the FICC as Sponsored Members. We would be supportive of a change that would limit expansion to cash investing entities only. However, we believe the current expansion of this program to include hedge funds and other risk-taking entities is anticompetitive.

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