May 27, 2022

Vanessa A. Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090

Re: File Number S7-12-22: Further Definition of “As a Part of a Regular Business” in the Definition of Dealer and Government Securities Dealer

Dear Ms. Countryman:

AlphaWorks Capital Management, LLC feels compelled to comment on the Securities and Exchange Commission (“SEC”) proposed rules (“Proposal”) that would require various participants in the wholesale U.S. Cash Treasury Market to be registered as Dealers. AlphaWorks does not support the proposed change, which we believe will degrade the quality and resiliency of the Market. Specifically, we think implementation of the Proposal will disproportionately hurt small firms, further shifting intermediation toward fewer, larger participants, and to futures. The fewer viewpoints will degrade order book quality and resiliency, and activity concentrated in fewer firms will increase systemic risk.

The remainder of this letter is organized as follows:

I. AlphaWorks background
   II. Description of the current Market
   III. SEC case for rule change
   IV. Responses to specific claims made or implied in the Proposal
   V. Summary

I. Our Firm

AlphaWorks Capital Management (“AlphaWorks”) is a small proprietary trading firm capitalized by its partners/principals. We do not operate as a Broker Dealer, Dealer, or Government Securities Dealer as defined by the Exchange Act in the U.S. Treasury market or any other. We do trade by buying and selling for our own account in the wholesale U.S. Treasury Markets and have done so since the firm’s founding in 2005. Our partners have deep experience in these and related markets dating to the 1980s. We have been active participants during the entire evolution of electronic trading of cash Treasuries and futures, including each of the three “disruptions” referenced in the Proposal.

Our trading style produces a type of liquidity coveted by exchanges, and the market generally. AlphaWorks is not a market maker, nor are our trading strategies designed or optimized for low latency. Our trading activity is predominately passive, and we’re typically most active when markets are most volatile. We diversify the order book, and we regularly add liquidity when it is in most demand.
II. Description of Current Market

A review of the current electronic wholesale Treasury market ("Market") will be helpful to appreciate our points later in the letter; this section briefly summarizes the market structure and systemic risk management regime of this Market. Furthermore, we provide some historical context for how it got here and where it’s likely to go.

A. Market Structure

Along with Treasury futures, the wholesale, or interdealer, market in on-the-run Treasury securities facilitates risk transfer in the broader Treasury market. This Market is dominated by three interdealer brokers ("IDBs") each with its own electronic public Central Limit Order Book ("CLOB" or "Exchange")\(^1\). Principal Trading Firms ("PTFs") and other sophisticated participants place orders with these Exchanges, updating the order books and generating trades. There are no retail traders on these platforms.

Exchange prices are widely disseminated to the public, with little or no delay. These order books differ across IDBs but are generally of high quality. Each IDB creates and modifies rules to encourage a healthy Exchange, and they’re incentivized to do this well: liquidity attracts trading, which generates fees. Participants abide by these rules to maintain access to the Exchange.

B. Systemic Risk Management

The current regime for systemic risk management consists of multiple layers. The most important layer resides at each participating firm, which is responsible for its orders and market risk. Self-capitalized PTFs have a strong incentive to manage this conservatively.

Access to the Exchange is granted by the IDB and is continually assessed. That assessment includes a risk limit, assigned to each firm by the IDB based on the capital set aside by the firm for trading, either with the IDB itself, or with a separate clearing firm. The IDB monitors every order, every trade, and position, real-time. They have the ability and authority to halt any order.

IDBs sit in an ideal position to protect the wider system from risks created by any participant. First, as a guarantor of their trades\(^2\), an IDB is incentivized to ensure non-Dealers trade responsibly. Of course, they also have a unique understanding of their Exchange and its interactions with orders, and they have a sophisticated knowledge of market risk generally along with a knowledge of each participant’s order history and patterns. Lastly, they can respond instantly to a problem.

The final layer of the current systemic risk mitigation is with the SEC itself. Each IDB is regulated by the SEC, which has access to every trade via FINRA/TRACE, and can obtain order-level detail for participant(s), upon request. There is no AlphaWorks U.S. Treasury Security trading activity that is presently hidden or otherwise obscured from SEC review.

\(^1\) Interdealer Brokers also have private or semi-private electronic Exchanges; trading in off-the-run securities; repurchase agreement trading; and voice brokering. AlphaWorks comments are restricted to electronic on-the-run Exchange trading.

\(^2\) Trades are either guaranteed by the IDB directly or indirectly through a clearing broker relationship.
It’s worth pointing out here that the Treasury futures market, which intermediates at least as much risk as the wholesale cash market, operates with a very similar regime. The CFTC regulates the exchange (CME), which regulates the participants, many of whom need no direct government registration regardless of activity or volume traded.

C. History and Prospects

As part of describing the present Market, it may be helpful to reflect on how and why it’s changed in recent years. First, as noted in the November 8, 2021 IAWG Joint Staff Report (“IAWG”)³, the size of the market has grown dramatically – up more than 400% between 2007 and 2021⁴. We suspect this has outstripped capital allocated to intermediation. Nevertheless, bid-ask spreads and market structure quality in general has never been better thanks in large part to non-Dealer PTFs.

This growth occurred during unprecedented interventions by the U.S. Federal Reserve (“Fed”), whose actions almost exclusively suppressed volatility, and by extension, trading volume. The reduced trading opportunities favored the fastest participants, who often employed similar strategies involving high-speed market making. Rising technology and communications costs accelerated a spiral toward consolidation. Smaller firms, and strategies requiring price volatility, largely exited the Market; new participants saw poor cost/benefit to enter.

This brings us to the present intermediation structure, which is dominated by a small number of large participants, many non-Dealers. These firms are quite effective at providing tight bid-ask spreads and, as detailed in the next section, the very few market disruptions have little or no evidence connecting the disruptions to PTFs despite great effort to do so. Nevertheless, fewer, larger participants running similar strategies means the market structure is more correlated, and systemic risk is more concentrated.

Looking forward, the Market size is expected to continue to grow⁵, but key actors are likely to change behavior. First, two of the largest purchasers of Treasuries over the last decade, Japan and China central banks, are no longer buying. A third, the Fed, has stopped net buying and will begin outright reducing its balance sheet in June. The Fed has also begun hiking the Federal Funds Rate, as well as raising its guidance about expected future hikes. In short, we expect more volatility in Treasury prices.

D. Summary

To summarize, the electronic wholesale market for U.S. Treasuries largely consists of three public Exchanges hosted by their owners, IDBs. For both Market structure and systemic risk, the IDBs define Exchange rules, monitor participants and control access, and the SEC regulates the IDBs; therefore, non-Dealer PTFs are subject to rules applied to the IDBs by the SEC. Furthermore, as we have detailed, incentives are aligned in the current structure to minimize systemic risk and maximize market structure quality.

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³ IAWG Joint Staff Report, Recent Disruptions and Potential Reforms in the U.S. Treasury Market, November 8, 2021.
⁴ Proposal, page 5; AlphaWorks calculated value derived from reported size of market in 2007 and reported size in 2021.
⁵ IAWG 2021, page 5; “The CBO projects continued growth in both the nominal debt and its size relative to GDP in the long run.”
In the last decade, the Market structure quality has been excellent despite the rapidly growing size of the Treasury market generally. Participation of PTFs, many of which are non-Dealers, grew substantially leading up to this period\(^6\) contributing significantly to this quality. Nevertheless, the future will likely be more volatile, suggesting the Market will need more, not fewer, participant voices to sustain this quality.

### III. SEC Case for Rule Change

Based on the Proposal itself and on public comments by Chair Gensler, the SEC’s motivation for new regulation centers on the following claims:

1. Market participants that trade through Dealers have regulatory costs and burdens that non-Dealer participants do not, creating an “uneven playing field”.

2. Non-Dealers pose unique risks to the Market structure – both to the general quality of Exchanges as well through heightened event risk, such as the “recent market disruptions”.

3. Non-Dealers pose unique systemic risks, or externalities.

The SEC proposal is to bring non-Dealers under direct SEC regulatory supervision. They claim, or imply, this additional oversight will (1) level the playing field, (2) improve the market structure and (3) reduce systemic risks. The Proposal places an estimate on direct compliance costs for participants and concedes that cost/benefits to the Market generally for the implementing rule change could be positive or negative.

### IV. AWC Responses to Claims Made in Proposal

#### 1. Uneven Playing Field

We don’t dispute that Market participants trading through Dealers have regulatory costs and burdens that non-Dealers don’t. However, registering all participants as Dealers will not create a level playing field. No playing field in business is level. Regulatory costs and burdens affect smaller firms more than bigger ones, and the biggest differential effects will be borne by small firms with no existing Dealer used for other business. Also, large firms already have many cost advantages including lower exchange fees, scaling larger volume across fixed infrastructure, communications, and personnel costs. The playing field is tilted toward larger firms, and the proof is in the trend toward fewer, larger firms dominating IDB trading.

#### 2. Non-Dealers Pose Unique Risks to Market Structure

The Proposal implies a causality between PTFs, especially non-Dealer PTFs, and “frequent market disruptions” to the Market structure\(^7\)\(^8\). This claim has two problems: (1) any disruptions haven’t been frequent – they identify just three events in 20+ years of electronic trading; and (2) the reports

\(^6\) See IAWG, page 5; “PTFs…by 2014, they represented the majority of trading activity in the futures and electronically brokered interdealer cash markets.”

\(^7\) See Proposal, page 26; “In the U.S. Treasury market, in particular, market commenters and financial regulators have stated that the rise of electronic trading and emergence of unregulated significant market participants over the years could be a contributing factor to the more frequent market disruptions, specifically stating that these changes are directly affecting liquidity provision.”

\(^8\) See Proposal; page 25; “…scrutiny of the U.S. Treasury market, in light of recent market disruptions, has identified a regulatory gap… “
referenced by the Proposal do not connect PTFs, much less non-Dealer PTFs, to any of the three events.

And while even three disruptions over 20+ years is hardly frequent; we dispute the existence of two of those three for any discussions about the IDB Market. Neither the Proposal nor the referenced reports present evidence connecting PTFs (or non-Dealer PTFs) to any of the documented events; in fact, evidence presented in these reports appear to exonerate them.

AlphaWorks traded through each of these events, and we have observations about the functioning of IDBs that we haven’t seen represented in the referenced reports or the SEC Proposal, and therefore are relevant for this discussion.

The first disruption, and the one most detailed in IAWG, happened in March 2020. IAWG claimed "The functioning of Treasury markets was significantly disrupted. Market liquidity deteriorated and the prices for closely related instruments diverged significantly."9 As a firm that traded throughout March of 2020 and experienced some of our largest trading volume days in recent memory, we were surprised to see this characterization, especially in the context of events at that time.

Markets were processing the biggest economic shock in a century with appropriately enormous price moves in ALL asset classes, including Treasuries. Yet the Exchange Market remained orderly, with almost twice the daily volume versus before and after that period. Bid-ask spreads were wider than typical10, but price moves reflected rapidly shifting outlooks for the world economy, and the spreads were narrower than might be expected given the price moves. Furthermore, we don’t see how more participants registered as Dealers would have improved the Market structure.

As IAWG highlights, bid-ask spreads for off-the-run Treasuries widened considerably. However, the report does not remind readers that off-the-runs are not part of the wholesale Exchange Market, where PTFs typically trade. Rather, off-the-runs trade primarily through Dealers on dealer-to-customer platforms. In contrast, IDB Exchanges, and PTFs (Dealers and non-Dealers), performed amazingly well, given the circumstances.

The second “disruption”, which occurred in September 2019, involved the repo market, which affected (again) off-the-run Treasuries and relationships between Treasuries and futures.11 To our knowledge, this event had nothing to do with, and did not materially affect, liquidity on the wholesale Market on IDB Exchanges.

The third event occurred in October 2014, over seven and a half years ago. This event involved a brief (12 min.), but very large, spike in Treasury prices, that was reflected, and traded, on IDB Exchange platforms. An inter-agency group was commissioned to study the event and issued a report in 2015 (“Joint Staff Report”)12. The following are some quotes from the report:

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9 See IAWG, page 7
10 See IAWG (page 12); Report highlighted that on March 13 the 10Y bid-ask spread increased to almost 3 times its typical level. AlphaWorks would like to point out (1) 10Y bid-ask spread averaged less than 2 times typical levels during U.S. hours that day; and (2) March 13 was a particularly volatile day digesting speculation about impending Fed intervention. Nevertheless, bid-ask spreads for 2Y, 3Y, 5Y, and 7Y all averaged less than 1.3 times typical levels that day (U.S. hours).
11 See IAWG 2021, page 18 (September 2019 repo market pressures)
• “Despite these [price] changes, trading volumes reached record highs, trading took place in a continuous manner during the event window”, p.3

• “…strong evidence suggests that PTFs, as a group, also remained engaged as liquidity providers throughout the event window...”, p.5

• “During the event window, bank dealers tended to widen their bid-ask spreads, and for a period of time provided no, or very few, offers in the order book in the cash Treasury market. At the same time, PTFs tended to reduce the quantity of orders they supplied, and account for the largest share of the order book reduction, but maintained tight bid-ask spreads.”, p.5

Nothing in the report suggested that PTFs as a group, or non-Dealer PTFs specifically, contributed to the disruption; in contrast, it sounds like PTFs performed better than bank Dealers during the window. Furthermore, the report stated:

• “By many metrics, the liquidity and efficiency of trading in the Treasury market are as robust as they have ever been.”, p. 6

To summarize, the Proposal claims that disruptions to the Market are frequent, and implies they’re caused by a “regulatory gap” between Dealers and non-Dealer participants on IDBs. Neither are true. By our accounting there’s been one “disruption” (Oct 2014) in 20+ years of electronic IDB trading, and even in that event PTFs maintained tight bid-ask spreads. And a thorough, multi-agency investigation of the 2014 event found no causal connection to PTFs, much less to non-Dealer PTFs.

3. Non-Dealers Pose Unique Systemic Risks, or Externalities

The Proposal claims new regulation is needed to stem system-wide risks and externalities posed by non-Dealers in the current regime. The opposite is true. If implemented, the additional regulation would be redundant with, and not as precise or timely as, the current systemic risk mitigation regime. And by concentrating market risk in fewer firms, the regulations will likely increase system-wide risks and potential externalities.

As we described in Section II, the existing multi-layer regime includes the SEC: they regulate the IDBs, who define Exchange rules, monitor participants, and control access. The SEC can view every IDB trade via TRACE/FINRA and can request order-level data from IDBs. IDBs are in a unique position to assess and mitigate market risk of Exchange participants in a timely manner and have every incentive to do it well. Furthermore, PTFs themselves, being capitalized by their trader/owners, have the most to lose from a systemic event they cause, and they have the technology and knowledge to monitor and minimize its likelihood.

If implemented, not only will the new regulations be redundant, they will increase overall system risk. Costs and burdens of the new regulations will cause firms – most likely smaller PTFs – to exit the Market, will discourage new firms from entering the Market, and will encourage migration of trading capital from cash Treasuries to futures. Intermediation will be done by fewer, bigger, firms, with less total capital. Even without the capital loss, a system with a small number of large nodes is more fragile than one with many smaller nodes. It gets worse. The few large nodes are likely to employ similar strategies, thus increasing the likelihood of simultaneous failure of multiple nodes.
Furthermore, the quality of the market structure degrades with diminished diversity of opinion and trading style.

4. Costs

The Proposal has an entire section discussing estimated costs of the new rules on affected participants.\(^{13}\) We find the extensive list of regulatory obligations daunting and we maintain it will act as a deterrent to existing participants and new entrants who may have a significant contribution to make to market diversity. We appreciate the Proposal made dollar estimates of compliance costs ($600K initially and $265K annually thereafter)\(^ {14}\), and acknowledged actual costs “may vary significantly”.\(^ {15}\) While we have no direct experience with Broker Dealers, we maintain these compliance estimates are considerably understated, especially for small firms.

One cost likely not included in the estimate is the burden placed on a firm’s non-compliance personnel. Annual audits are common under Dealer registration and can take a significant number of hours from a firm’s traders, researchers and technologists to participate in audit meetings. Their time is also required for any SEC system or trade review. While $265K/yr might include the additional cost of compliance personnel, it cannot possibly account for the dozens—or hundreds—of annual hours likely required by non-compliance personnel.

All costs matter to a business, and fixed costs hit smaller firms harder. The burdens of the new rules on non-compliance personnel will be especially heavy to small firms and new entrants to the marketplace. We firmly believe the direct and indirect costs of implementing these rules will cause a reduction in the number of participants in the Market. Many small firms will exit the Market altogether, or look to merge with larger firms, where their strategies may be eliminated or their orders internalized before reaching the Market. Either way, fewer viewpoints will reach the public IDB exchange, reducing the Market’s liquidity and resiliency.

Buried deep in the Proposal, in its discussion of effects of the rule change on efficiency, competition, and capital formation, the document concedes many of our points about the costs to the Market:

- “...registration and compliance costs could lead some currently-unregistered liquidity providers to decrease their activity or even exit the market.”, p. 141
- “Changes in patterns of market participation could affect market efficiency, market competition, and capital formation.”, p. 142
- “…if important and informed market participants, such as PTFs or hedge funds, permanently reduce their market activity or their pursuit of certain investment strategies, market efficiency may decline in the markets for some securities.”, p.142
- “…direct costs that the Proposed Rules would impose on currently unregistered firms who currently engage in covered activities may cause them to scale back these activities.”, p. 143
- ”...registering PTFs as dealers would negatively impact competition among liquidity providers by creating barriers to entry.”, p. 144

\(^ {13}\) See Proposal pages 135-141
\(^ {14}\) See Proposal page 135
\(^ {15}\) See Proposal page 135
• “...may cause some market participants to scale back or exit certain liquidity-providing strategies in order to avoid registration; or, even if they do not, compliance costs including net capital requirements might lead them to scale back some activities.”, p. 145

Acknowledgement of these costs to the Market while not identifying offsetting benefits undermines the foundation for the Proposal.

V. Summary

We believe implementation of the proposed rules will harm the quality and resiliency of the Market. The increased costs and burdens of the rules will reduce viewpoints in the Market, particularly those of smaller firms that often have the most diverse strategies and trading styles. The fewer viewpoints will produce Exchanges that are less liquid and resilient, and system risk concentrated in fewer hands.

Furthermore, we believe the stated motivations for the rules are based on mischaracterizations, or misunderstandings, of the current Market and the role PTFs and non-Dealer PTFs play in it. We dispute that Market “disruptions” are either frequent or caused by a “regulatory gap”. And we contend the rules will add nothing substantive to the current regime to reduce systemic risk.

We firmly believe this Proposal will harm the Market and will do so at a delicate moment in its history. We share the concern about the health and effectiveness of Treasury intermediation as we enter a more volatile period, however, we believe the answer is to encourage more, rather than fewer, market viewpoints and participants.

Sincerely,

The Partners of AlphaWorks Capital Management, LLC

John Kapustiak, Managing Partner
Brian Staunton, Partner
Matthew Schwingel, Partner

cc: Gary Gensler, Chair
    Hester M. Peirce, Commissioner
    Allison H. Lee, Commissioner
    Caroline A. Crenshaw, Commissioner