The SEC’s Proposed Rule for Definition of Dealer and Government Securities Dealer

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I. Executive Summary

1. The purpose of this report is to provide economic analysis to assist the United States Securities and Exchange Commission (the “SEC” or the “Commission”) in its deliberations with respect to new rules proposed under the Securities Exchange Act of 1934 (the “Exchange Act”) entitled “Further Definition of ‘As a Part of a Regular Business’ in the Definition of Dealer and Government Securities Dealer.”

2. Based on my review of the proposed rules, and my own experience and discussions with market participants, it is my opinion that:

   a. The Commission has not provided a reasoned basis for designating private funds as government securities dealers, or why this is the correct regulatory solution to address asserted concerns about resiliency, transparency, and investor protection in the market for U.S. Treasuries cash securities (“U.S. Treasury Market”). The designation of private funds as government securities dealers does not address the Commission’s primary concerns, and the economic analysis in the Proposing Release fails to consider reasonable alternatives that could better address these concerns.

   b. The Commission has failed to provide sufficient support for its proposal to use a “bright-line” quantitative threshold to designate government securities dealers. The use of any quantitative threshold risks imposing costs on firms that are not engaging in the so called “dealer-like” activities the Commission proposes to regulate. Additionally, the Commission has presented insufficient economic analysis to justify why a $25 billion monthly volume threshold is the appropriate level if such a quantitative threshold is used.

   c. The Commission has failed to consider all potential costs associated with the proposed rules. The economic analysis in the Proposing Release understates the direct costs that would be imposed on newly registered government securities dealers, and fails to appropriately account for certain indirect costs.

   d. The Commission has failed to rigorously analyze the economic consequences of the proposed rules, as it does not adequately consider how participants in

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1 “Further Definition of ‘As a Part of a Regular Business’ in the Definition of Dealer and Government Securities Dealer;” 87 FR 23054, April 18, 2022 (“Proposing Release”).
this market will react to the proposed rules and what impact their reactions will have on the U.S. Treasury Market and other markets. Academic literature has shown that imposing thresholds for registration may impact investor behavior, and this change in behavior could harm market quality in the U.S. Treasury Market. Further, the Commission has also failed to consider the impact these changes in behavior could have on market quality for other markets closely connected to the U.S. Treasury Market, such as the market for U.S. Treasury futures. Therefore, the Commission has failed to demonstrate that the proposed rules will not negatively impact efficiency, competition, and capital formation.

e. Finally, the Proposing Release fails to jointly consider the possible impact of other proposed rules with potentially similar indirect costs.

II. Overview of the Proposed Rules

3. On March 28, 2022, the Commission issued for public comment a set of proposed rules regarding the statutory definitions of “dealer” and “government securities dealer” under the Securities Exchange Act of 1934. According to the Commission, it is proposing “standards to identify those market participants that are providing an important liquidity provision function in today’s securities markets.” As such, “[a]ny person that meets the activity-based standards identified in the Proposed Rules would be a dealer or government securities dealer required to register, absent an otherwise available and applicable statutory or regulatory exemption or exception.” Overall, the Commission proposes three qualitative standards to identify both “dealers” and “government securities dealers,” alongside one quantitative standard meant to exclusively identify “government securities dealers.”

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2 Proposing Release. The statutory definitions of “dealer” and “government securities dealer” are found under Sections 3(a)(5) and 3(a)(44), respectively, of the Securities Exchange Act of 1934. Specifically, per p. 23056, footnote 24 of the Proposing Release: “Section 3(a)(5) of the Exchange Act defines the term ‘dealer’ to mean ‘any person engaged in the business of buying and selling securities . . . for such person’s own account through a broker or otherwise,’ but excludes ‘a person that buys or sells securities . . . for such person’s own account, either individually or in a fiduciary capacity, but not as a part of a regular business.’” Similarly, Section 3(a)(44) of the Exchange Act, provides, in relevant part, that the term “government securities dealer” means “any person engaged in the business of buying and selling government securities for his own account, through a broker or otherwise,” but “does not include any person insofar as he buys or sells such securities for his own account, either individually or in some fiduciary capacity, but not as part of a regular business.”

3 Proposing Release, p. 23056.
4 Proposing Release, p. 23056.
5 Proposing Release, pp. 23061–23062, 23065. The proposed rules would not be the sole means of identifying “dealers” and “government securities dealers”: “While the Proposed Rules would establish standards that
4. The Commission proposes three qualitative standards, which the Commission argues are built on factors identified over the years by courts and the SEC and “designed to more specifically identify activities of certain market participants who assume dealer-like roles, specifically, persons whose trading activity in the market ‘has the effect of providing liquidity’ to other market participants.” The three standards are:

a. “[r]outinely making roughly comparable purchases and sales of the same or substantially similar securities (or government securities) in a day;”

b. “[r]outinely expressing trading interests that are at or near the best available prices on both sides of the market and that are communicated and represented in a way that makes them accessible to other market participants;” and

c. “[e]arning revenue primarily from capturing bid-ask spreads, by buying at the bid and selling at the offer, or from capturing any incentives offered by trading venues to liquidity-supplying trading interests.”

5. Alongside the qualitative standards, the Proposing Release lays out a quantitative standard to identify “government securities dealers” that “would establish a bright-line test, under which a person engaging in certain specified levels of activity would be deemed to be buying and selling government securities ‘as a part of a regular business,’ regardless of whether it meets any of the qualitative standards.” Specifically, the Proposing Release foresees a standard whereby “a person that is engaged [in] buying and selling government securities for its own account is engaged in such activity ‘as a part of a regular business’ if that person in each of four out of the last six calendar months, engaged in buying and selling more than $25 billion of trading volume in government securities…”

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identify when a person is acting as a dealer or government securities dealer, whether a person’s activities meet these standards would remain a facts and circumstances determination. Importantly, the Proposed Rules are not the exclusive means of establishing that a person is a dealer or government securities dealer—to the extent consistent with the Proposed Rules, existing Commission interpretations and precedent will continue to apply.”

See Proposing Release, p. 23062.

6 Proposing Release, pp. 23061–23062.

7 Proposing Release, pp. 23065, 23066–23070 ("the Proposed Rules identify three patterns of buying and selling that the Commission views as having the effect of providing liquidity—any one of which is sufficient to require a person to register as a dealer.").

8 Proposing Release, pp. 23072. The Commission states that “the quantitative standard is derived from trading data related to the U.S. Treasury market, and is intended to identify significant market participants not registered as dealers that are performing dealer-like activities in the U.S. Treasury market.”

9 Proposing Release, p. 23072. See also p. 23072 (“In determining whether the trading volume threshold is met, a market participant would include transactions in U.S. Treasury Securities that are currently reported to TRACE—that is, Treasury bills, notes, floating rate notes, bonds, TIPS, and STRIPS—and would exclude auction awards and repurchase or reverse repurchase transactions in U.S. Treasury Securities.”).
6. Under the proposed rules, firms identified as either “dealers” or “government securities dealers” must “register with the Commission and become members of a self-regulatory organization (‘SRO’); comply with Commission and SRO rules, including certain financial responsibility and risk management rules, transaction and other reporting requirements, operational integrity rules, and books and records requirements.”\(^{10}\) The firms must also “comply with specific anti-manipulative and other anti-fraud rules.”\(^{11}\) Further, “government securities dealers” are also required to “comply with rules adopted by Treasury, including but not limited to rules relating to financial responsibility, recordkeeping, financial condition reporting, risk oversight, and large trader reporting.”\(^{12}\)

7. As justification for the proposed rules, the Commission claims that “[a]dvancements in electronic trading across securities markets have led to the emergence of certain market participants that play an increasingly significant liquidity providing role in overall trading and market activity [and that…] these market participants—despite engaging in liquidity providing activities similar to those traditionally performed by either ‘dealers’ or ‘government securities dealers’…—may not be registered with the Commission as either dealers or government securities dealers.”\(^{13}\) Because of this, the Commission claims, “investors and the markets lack the important protections that result from an entity’s registration and regulation under the Exchange Act.”\(^{14}\) Furthermore, the Commission claims that “obligations and regulatory oversight that promote market stability and investor protection are not being consistently applied to entities engaged in similar activities.”\(^{15}\)

8. The Commission also states that “scrutiny of the U.S. Treasury market, in light of recent market disruptions, has identified a regulatory gap in terms of the registration status and regulation of significant market participants in the U.S. Treasury market [and that…] the activity of significant market participants that are not registered may pose certain risks to the markets.”\(^{16}\) The Commission states:

“In the U.S. Treasury market, in particular, market commenters and financial regulators have stated that the rise of electronic trading

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\(^{10}\) Proposing Release, pp. 23060–23061. See also p. 23061 (“Importantly, dealers and government securities dealers are subject to Commission and SRO examination, inspection, and enforcement for compliance with applicable Federal securities laws and SRO rules.”).

\(^{11}\) Proposing Release, p. 23061.

\(^{12}\) Proposing Release, p. 23061.

\(^{13}\) Proposing Release, p. 23054.

\(^{14}\) Proposing Release, p. 23054.

\(^{15}\) Proposing Release, p. 23054.

\(^{16}\) Proposing Release, p. 23060.
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.”

9. The Commission believes that “the operation of the rules will support transparency; market integrity and resiliency; and investor protection; across the U.S. Treasury Market and other securities markets by closing the regulatory gap that currently exists and ensuring consistent regulatory oversight of persons engaging in the type of activities described in the Proposed Rules.” The Commission also states that the proposed rules “would improve the Commission’s ability to monitor market activity, conduct research, and detect manipulation and fraud.”

10. However, the Commission acknowledges that “the Proposed Rules will not by themselves necessarily prevent future market disruptions,” and that “[t]he Proposed Rules would have uncertain impacts on efficiency, competition, and capital formation, due to the likelihood of offsetting effects … due to costs that the Proposed Rules would impose on activities that provide liquidity.”

11. In what follows, Section III expands on the economic analysis contained in the Proposing Release and explains that it is incomplete and fails to provide a reasoned basis for the proposed rules. Section IV discusses more general implications of the Proposing Release for market quality across several related markets. Section V discusses how the Commission fails to jointly consider the possible impact of other proposed rules with potentially similar indirect costs.

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17 Proposing Release, p. 23060.
18 Proposing Release, p. 23060. According to the Commission, “[t]he requirement that dealers register has been repeatedly recognized as being ‘of the utmost importance in effecting the purposes of the [Exchange] Act. It is through the registration requirement that some discipline may be exercised over those who may engage in the securities business and by which necessary standards may be established with respect to training, experience, and records.’” See Proposing Release, p. 23060.
19 Proposing Release, p. 23078.
20 Proposing Release, p. 23060.
21 Proposing Release, p. 23078 (“Section 3(f) of the Exchange Act requires the Commission, whenever it engages in rulemaking pursuant to the Exchange Act and is required to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action would promote efficiency, competition, and capital formation.”).
III. The Economic Analysis Contained in the Proposing Release Is Incomplete and Does Not Provide a Reasoned Basis for Designating Private Funds as Government Securities Dealers

A. The Proposed Use of a “Bright-Line” Quantitative Threshold to Designate Government Securities Dealers May Identify and Impose Costs on Firms that Are Not Engaging in “Dealer-Like” Activities

12. The Commission’s proposal to designate any firm that transacts $25 billion or more per month in U.S. Treasuries as a government securities dealer has several flaws. First, the use of any quantitative threshold to designate firms as government securities dealers risks imposing unnecessary costs on firms that are not engaging in the type of “dealer-like” activities the Commission has identified. Second, the Commission has presented insufficient economic analysis to justify why a $25 billion monthly volume threshold is the appropriate level to identify a firm as a government securities dealer.

13. As an initial matter, the use of any quantitative threshold means that a firm can be designated as a government securities dealer based solely on trading volume, regardless of whether it is actually “providing an important liquidity provision function in today’s securities markets.” The Commission recognizes the possibility that quantitative thresholds can lead to faulty designations, which is why it is also proposing qualitative standards. However, the Proposing Release does not currently foresee a framework in which the proposed qualitative standards can provide exemption for a faulty designation under the proposed quantitative threshold. As such, the proposed qualitative standards do not remedy the issues with the quantitative threshold that the Commission itself established could impose costs on firms that are not (under the Commission’s view) “important liquidity providers”:

"thus burdening these firms with all of the registration costs described above without doing much to enhance market stability or improve regulators’ insight into market activity (since such firms do not play central market roles)."

14. In addition, the Commission acknowledges that it currently does not even have a quantitative framework by which to reliably evaluate the proposed quantitative standard: “at present we do not have a reliable quantitative framework for defining liquidity provision.”

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22 See Section II above for a more detailed description of how the proposed threshold is defined and how the amount transacted is to be calculated by market participants.
23 Proposing Release, p. 23056.
24 Proposing Release, p. 23094.
15. As an illustration of this point, the Commission makes a distinction between (i) dealers and (ii) investors who buy to hold, the latter of which (the Commission asserts) would generally be exempted from dealer classification.\(^ {26}\) However, it is possible that a firm pursuing a strategy of buying and holding, if it is doing so in excess of the proposed threshold, will still trigger registration even if it is not performing a “dealer-like role” in the marketplace. Imposing the costs of registration on this firm would be inconsistent with the Commission’s intent of identifying firms which “serve dealer-like roles.”\(^ {27}\) This possibility is acknowledged in the Proposing Release:

“A large-volume basis trading hedge fund could hypothetically be captured by the quantitative standard, but a recent study suggests that few, if any, basis trades involve enough Treasury trading volume to meet the threshold of $25 billion per month in four out of the past six calendar months.”\(^ {28}\)

16. It is not at all clear, however, that the study referenced supports the Commission’s assertion that “few, if any, basis trades involve enough Treasury trading volume to meet the threshold of $25 billion.” Per the Proposing Release, the study found that in 2019 “the aggregate basis trade of the 44 largest participants held a long Treasury position of about $400–$500 billion (an average of only about $9–$11 billion per large basis trader).”\(^ {29}\) However, since some of the “44 largest participants” engaged in basis trading (i) will likely have a long Treasury position that is greater than the $9–$11 billion average, (ii) may routinely both open and close long Treasury positions, (iii) may also be engaged in other investment, trading, or hedging activity involving U.S. Treasuries, and (iv) the proposed quantitative threshold counts both purchases and sales of Treasury securities, it is not at all clear on what grounds the Commission concludes that only “few, if any, basis trades” involve enough trading volume to meet the proposed quantitative threshold.

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\(^ {26}\) Proposing Release, pp. 23057–23058, 23059. Proposing Release, p. 23059 (“The Commission has stated that dealers include those who are willing to buy and sell contemporaneously and often quickly enter into offsetting transactions to minimize the risk associated with a position. In contrast, traders are ‘market participants who provide capital investment and are willing to accept the risk of ownership in listed companies for an extended period of time,’ and the Commission has stated ‘it makes little sense to refer to someone as ‘investing’ in a company for a few seconds, minutes, or hours.’ The purpose of the ‘trader’ exception is to ‘exclude from the definition of ‘dealer’ members of the public who buy and sell securities for their own account as ordinary traders.’”).

\(^ {27}\) Proposing Release, p. 23072 (“The proposed quantitative standard is intended to be a straightforward threshold identifying those market participants that, as a result of their regularly high trading volume in government securities, serve dealer-like roles significantly impacting the U.S. Treasury market.”).

\(^ {28}\) Proposing Release, pp. 23082–23083. The Commission’s analysis identified “at least one hedge fund … that surpassed the quantitative standard’s threshold of $25 billion in U.S. Treasuries in July 2021.”

\(^ {29}\) Proposing Release, p. 23083.
17. In addition to failing to justify the use of any quantitative threshold, the Commission does not provide sufficient economic evidence for its choice of a $25 billion monthly volume threshold more specifically. The Commission explains that its selection of the threshold was based on an analysis of TRACE data and purports to consider the number of firms likely to be affected.\textsuperscript{30} Specifically, the Commission’s analysis identified 46 non-FINRA members which, subject to the numerous uncertainties associated with the Commission’s extrapolation based on limited data, had implied trading volumes of $25 billion or more in July 2021.\textsuperscript{31} At least one hedge fund is among the 46 firms identified.\textsuperscript{32} There are several flaws with the Commission’s analysis to support its arbitrary threshold, three of which are outlined below.

18. First, the Commission’s analysis was conducted based on incomplete data, as it was “limited to the subset of TRACE data where [the Commission] can identify the individual firms.”\textsuperscript{33} The analysis assumes that “all non-FINRA member market participants are equally represented in both the anonymous and identified subsets of TRACE.”\textsuperscript{34} However, as the Proposing Release acknowledges, that assumption is faulty: “[n]on-FINRA member participants generally appear anonymously when they trade with FINRA members, who report their activity to TRACE but maintain the anonymity of the non-FINRA member counterparties.”\textsuperscript{35} Specifically, it is when “non-FINRA member participants trade on an [alternative trading system (“ATS”)] that is covered by FINRA Rule 6730.07” that the non-member’s identity is identifiable in TRACE,\textsuperscript{36} and ATS activity is more pronounced in the interdealer segment of the U.S. Treasury Market than the dealer-to-customer market.\textsuperscript{37}

\textsuperscript{30} Proposing Release, p. 23072 (“the proposed trading volume threshold was derived from analysis of historical U.S. Treasury Securities transactions reported to TRACE”); p. 23092 (“The threshold that maximizes the Proposed Rule’s benefits (by including firms responsible for a large percentage of trading volume) while minimizing costs (by limiting the number of firms that will be required to register) appears to be somewhere around $10 billion.”).

\textsuperscript{31} Proposing Release, p. 23081. Per the breakdown provided in the Proposing Release’s Table 1, 20 of these 46 non-FINRA members appear to already be registered as “dealers.” See Proposing Release, p. 23081. The Proposing Release states that “[a]s used in this release, the term ‘dealer’ refers to both dealers and government securities dealers unless explicitly noted or the context indicates otherwise.” However, no specific definition of “dealer” appears to have been provided for Table 1. See Proposing Release, p. 23054, footnote 3.

\textsuperscript{32} Proposing Release, p. 23082. The number of hedge funds is suppressed in the breakdown provided in the Proposing Release’s Table 1. See Proposing Release, p. 23081. However, as the Commission acknowledges, “[a]dditional hedge funds may meet the quantitative threshold beyond those we observe—for instance, hedge funds who trade outside of covered ATSs and so only appear in TRACE anonymously, or hedge funds that trade with other non-FINRA members (such as banks) and so do not appear in TRACE at all.” See Proposing Release, p. 23082.

\textsuperscript{33} Proposing Release, p. 23081.

\textsuperscript{34} Proposing Release, p. 23081.

\textsuperscript{35} Proposing Release, p. 23080, footnote 217.

\textsuperscript{36} Proposing Release, p. 23080, footnote 217.

Meanwhile, as acknowledged by the Commission, hedge funds may trade with dealers and others “outside of covered ATSs and so only appear in TRACE anonymously, or … with other non-FINRA members (such as banks) and [therefore] not appear in TRACE at all.”38

19. As such, there are numerous uncertainties associated with the Commission’s extrapolations based on its limited data, which means that “the numbers of firms with trading volume above the various thresholds may be greater than” the Commission’s estimates.39 In fact, the data analyzed by the Commission may provide little to no view into the Treasury trading activity of private funds. As a result, the Commission is unable to appropriately calibrate a quantitative threshold or accurately estimate the number of firms that would be captured by the proposed rules.

20. Second, the Commission considers a sensitivity analysis to understand the relationship between the quantitative threshold and the number of non-FINRA members identified, but appears to arbitrarily select a threshold without any rigorous analysis to support its choice.40 While the Commission states that

“[t]he threshold that maximizes the Proposed Rule's benefits (by including firms responsible for a large percentage of trading volume) while minimizing costs (by limiting the number of firms that will be required to register) appears to be somewhere around [the proposed threshold].”41

the Proposing Release does not provide any analysis to quantify the benefits and costs or to otherwise support the Commission’s claim that the proposed threshold maximizes benefits while minimizing costs.

21. Third, the Proposing Release does not sufficiently consider the size of the proposed threshold relative to the current, or future, size of the U.S. Treasury Market. According to the Securities Industry and Financial Markets Association (SIFMA), the average daily trading volume of U.S. Treasuries is ~$680 billion per day.42 This would correspond to $14.3 trillion

(“Alternative Trading Systems (ATSs) have become a significant source of orders and trading interest for government securities, particularly in the interdealer market.”).

38 Proposing Release, p. 23082.
39 Proposing Release, p. 23081.
40 Proposing Release, pp. 23092–29093.
41 Proposing Release, p. 23092. For instance, Figure 2 of the Proposing Release implies that, out of the 46 non-FINRA members identified under the proposed threshold, the largest 23 account for more than 90% of their joint trading volume and the largest 14 alone account for more than 80% of their joint trading volume. See Proposing Release, p. 23093.
on a monthly basis.\textsuperscript{43} As such, the proposed monthly threshold of $25 billion would identify and subject to the proposed rules any firm that accounts for more than 0.175\% of the total market’s monthly volume.\textsuperscript{44} However, the Commission has not provided sufficient analysis or evidence to demonstrate that a firm which accounts for 0.175\% of the market’s total monthly trading volume is “providing an important liquidity provision function in today’s securities markets.”\textsuperscript{45} Indeed, the Commission acknowledges that “at present we do not have a reliable quantitative framework for defining liquidity provision.”\textsuperscript{46}

22. Moreover, given that the proposed threshold is neither inflation-adjusted nor indexed to the current size of the U.S. Treasury Market, as the volume of outstanding Treasury securities grows, the proposed threshold will likely represent a smaller share of the market’s total monthly trading volume.\textsuperscript{47} As the Commission acknowledges, between 2007 and 2021, the value of outstanding Treasury securities “increased substantially” by \textasciitilde350\% from $5.1 trillion to $23.1 trillion.\textsuperscript{48} Per projections from the Congressional Budget Office (“CBO”), over the next 10 years, the value of outstanding Treasury securities is expected to continue to grow and exceed $40 trillion by 2032.\textsuperscript{49} Although corresponding projections of Treasury trading volume are not included in the CBO projections, trading volume is likely to grow as the Treasury market grows.\textsuperscript{50}

\textsuperscript{43} Based on $679.1 billion multiplied by an average of 21 trading days per month (679.1 \times 21 = 14,261.1).
\textsuperscript{44} Based on $25 billion divided by $14,261.1 billion (25 / 14,261.1 = 0.175\%). A specific “Request for Comment” in the Proposing Release addresses the threshold issue: “Is the threshold of more than $25 billion of trading volume in each of four out of the last six calendar months an appropriate proxy for determining whether a person is engaged in buying and selling U.S. Treasury Securities for its own account is engaged in such activity as a part of a regular business? Why or why not? If not, what thresholds would be appropriate? For example, should the quantitative standard include a separate trading volume threshold for: (1) buying; (2) selling; and (3) both buying and selling U.S. Treasury Securities, all three of which would be required to be satisfied in order to meet the quantitative standard? Commenters should provide data to support their views.” See Proposing Release, p. 23073.
\textsuperscript{45} Proposing Release, p. 23056.
\textsuperscript{46} Proposing Release, p. 23094.
\textsuperscript{47} A specific “Request for Comment” in the Proposing Release addresses the threshold indexing issue: “Should the quantitative standard be a dynamic trading volume threshold that changes with the market over time, such as percentage of transactions reported to TRACE, a percentage of U.S. Treasury Securities outstanding or issued, or other inflation-adjusted threshold? Why or why not?” See Proposing Release, p. 23073.
\textsuperscript{48} Proposing Release, pp. 23054–23055.
\textsuperscript{49} See “Budget and Economic Data: 10-Year Budget Projections,” CBO, May, 2022. See also “The Budget and Economic Outlook: 2022 to 2032,” CBO, May 2022 (“Relative to the size of the economy, federal debt held by the public is projected to dip over the next two years, to 96 percent of GDP in 2023, and to rise thereafter. In CBO’s projections, it reaches 110 percent of GDP in 2032 (higher than it has ever been) and 185 percent of GDP in 2052 … Moreover, if lawmakers amended current laws to maintain certain policies now in place, even larger increases in debt would ensue.”).
B. The Proposed Rules Will Not Address Some of the Primary Causes of the Market Disruptions that They Are Purportedly Aimed at Preventing

23. As discussed in Section II, the Commission states that the objective of the proposed rules is to provide stability and transparency in the U.S. Treasury Market, as (according to the Commission) there are market participants “who effectively provide liquidity” but are not constrained by existing dealer regulations that are “designed to limit risk-taking,” such as “leverage constraints.” The Commission asserts that this may cause “instability…when a stressed liquidity provider temporarily reduces its activity.” The Commission cites the market volatility in March 2020 as an example and asserts that “[i]nformation limitations in the market for U.S. Treasury securities became especially apparent” during this episode and that “[principal trading funds (‘PTFs’)] (most of whom are not registered as dealers) appeared to especially pull back from market-making activity, possibly because ‘their lower capitalization relative to dealers may [have left] them with less capacity to absorb adverse shocks.’” However, irrespective of the validity of this assertion, as discussed below, the proposed rules are not limited to PTFs and do not address several of the primary causes of the March 2020 instability, instead imposing costs on firms that may have contributed positively to market stability and liquidity during the March 2020 episode in the U.S. Treasury Market.

24. The focus of the proposed rules on certain market participants currently not registered as government securities dealers (for example, customers of broker-dealers) appears to be based, at least in part, on an early and misleading narrative about the effect of their use of leverage to the instability of March 2020. While in the aftermath of March 2020, “some commentators speculated that hedge funds were the main cause [of] the market volatility,” more recent research points to the actions of other market participants to explain the instability of March 2020. Specifically, recent studies of the March 2020 episode have 1) identified other market participants as the primary cause of the initial price movement and 2) found evidence suggesting that hedge funds were not the primary cause of the stress observed in the U.S. Treasury Market. Both of these findings raise questions about the Commission’s

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51 Proposing Release, p. 23085. The Proposing Release states that “net capital requirements limit the leverage that dealers are allowed to take on, while PTFs and private funds have no regulatory leverage constraints” and “estimate that qualifying hedge funds are more leveraged than registered dealers.”
52 Proposing Release, pp. 23085–23086.
53 Proposing Release, p. 23086.
54 Proposing Release, p. 23086.
55 “IOSCO Investment Funds Statistics Report,” International Organization of Securities Commissions, January 2022 (‘IOSCO Report’), p. 22 (“For example, Schimpft et al (2020) suggest that relative value hedge funds were a major source of the dislocation.”).
assertion that the additional regulation of hedge funds in the proposed rules will add stability and transparency to the U.S. Treasury Market during volatile periods such as March 2020.\textsuperscript{56}

25. First, several studies of the U.S. Treasury Market instability during March 2020 have found that the disruption was primarily the result of activity by foreign central banks and registered mutual funds (rather than hedge funds), as these market participants held the largest portfolios of U.S. Treasury securities in March 2020 and were engaged in large-scale selling.\textsuperscript{57} For example, data show foreign treasury accounts were large net sellers in the month of March 2020.\textsuperscript{58} Similarly, “mutual funds appear to have sold in exceptionally large volumes” as “net sales of Treasuries by domestic mutual funds totaled almost $200 billion in the first quarter [of 2020], the largest quarterly decline on record.”\textsuperscript{59} Despite the primary role these market participants played in the March 2020 market movements via their large-scale selling as revealed by studies of the episode, the proposed rules do not impact the regulation of either of these entities.\textsuperscript{60} Further, the Commission has not considered how the proposed rules’ treatment of foreign firms, despite their role in the U.S. Treasury market, may affect the competitiveness of the market by potentially disadvantaging U.S. firms.

26. Second, subsequent research has also reexamined the trading behavior of hedge funds in March 2020. Some studies have determined that the “positions held by hedge funds were far too small to be the main disruptive factor.”\textsuperscript{61} For example, Barth and Kahn (2021) find

\textsuperscript{56} Proposing Release, p. 23054.

\textsuperscript{57} IOSCO Report, p. 22. See also IAWG Report, p. 9 (“Foreign official and private investors. Foreign investors were significant net sellers of Treasury securities. More than half of the net sales were by foreign official institutions, such as central banks that sought to support local currencies.”); Daniel Barth and R. Jay Kahn, “Hedge Funds and the Treasury Cash-Futures Disconnect,” \textit{OFR Working Paper 21–01}, 2021 (“Barth and Kahn (2021)”), p. 46 (“The illiquidity in Treasury markets seems to have been spurred by large sales from foreign and domestic real money investors, particularly foreign central banks and domestic mutual funds.”).

\textsuperscript{58} Barth and Kahn (2021), p. 46 (“Treasury International Capital System data show that net decreases in foreign Treasury positions were around $257 billion in the month of March, with a decrease of $147 in foreign official accounts.”). See also Lorie K. Logan, “Treasury Market Liquidity and Early Lessons from the Pandemic Shock,” \textit{Federal Reserve Bank of New York}, October 23, 2020 (“Foreign official accounts… were also large net sellers, as shown by data from official accounts held at the New York Fed depicted in Figure 5.”).

\textsuperscript{59} Lorie K. Logan, “Treasury Market Liquidity and Early Lessons from the Pandemic Shock,” \textit{Federal Reserve Bank of New York}, October 23, 2020 (“Mutual funds appear to have sold in exceptionally large volumes, as these funds monetized their most liquid asset holdings to prepare for potential redemptions and rebalance their portfolios … net sales of Treasuries by domestic mutual funds totaled almost $200 billion in the first quarter, the largest quarterly decline on record.”).

\textsuperscript{60} For example, the proposed rules will not apply to mutual funds because they are already registered under the Investment Company Act of 1940. See Proposing Release, p. 23056, footnote 28. See also Proposing Release, p. 23056, footnote 29 (“The Commission is not expressing any views concerning multilateral development banks, like the International Bank for Reconstruction and Development (or the World Bank) and the International Finance Corporation, or foreign sovereigns or foreign central banks, or any other sovereign or international bodies as to the immunities such entities may possess under U.S. or international law.”).

that hedge funds partially unwound “basis positions” from $659 billion to $554 billion between February 18, 2020 and March 17, 2020.62 This decrease in position size was smaller than that observed by both foreign accounts and mutual funds, and was “significantly less than that which is necessary to move the multi-trillion dollar Treasury market.”63 Moreover, it is not clear from the studies to what extent all hedge funds participated in this partial unwind of basis positions. For example, some hedge funds were also reported to have raised new funds to invest in the market at that time.64

27. Studies have also found that the market for the types and maturities of Treasury securities most commonly traded by hedge funds saw more robust liquidity than other types and maturities during the instability of the March 2020 episode. Hedge funds engaged in basis trades were more likely to have long Treasury positions “concentrated in a specific type of Treasury, the cheapest-to-deliver [t]reasuries.”65 Therefore, selling by hedge funds during the March 2020 instability would have been likely to be concentrated in the cheapest-to-deliver Treasuries. Yet, studies have found that the cheapest-to-deliver Treasuries did not show the same level of dislocation as other parts of the U.S. Treasury Market and continued to trade at a premium.66 This price pattern is counter to what would be expected if hedge funds unwinding basis trade positions had actually precipitated the market dislocation.67 Therefore, it seems likely that while the overall market stress in March 2020 may have led

62 Barth and Kahn (2021), p. 4. See also Di Maggio (2020), p. 3 (“Picking up on this analysis, some began to estimate that FI-RV participants unwound $90 billion of their Treasury holdings (Bank of England, 2020).”
63 Di Maggio (2020), p. 3 (“Our calculations suggest that FI-RV hedge fund positions were not large enough to disrupt the market to the extent that we observed, as their total size, even after accounting for leverage, was still significantly less than that which is necessary to move the multi-trillion dollar Treasury market.”).
67 Barth and Kahn (2021), pp. 52–53 (“If selling pressure from hedge funds exiting the basis trade had significantly harmed Treasury liquidity, we would expect the price of the cheapest-to-deliver securities to have fallen relative to comparable securities as dealers accumulated large net exposure to these specific Treasuries. That the premium rose suggests that any selling pressure was offset by the liquidity that the basis trade provides and the link it establishes to futures markets. This link may have become particularly valuable during the general flight to liquidity during March, and reduced pressure on dealers purchasing the cheapest-to-deliver. As a result, while the general evidence points to sales of the basis by hedge funds during March, we do not find evidence that these sales in turn caused greater illiquidity in the Treasury market. While many of the risks of this trade seem to have materialized, evidence of spillovers into Treasury liquidity and short-term funding disruptions are limited.”).
some hedge funds to sell Treasuries (alongside many other categories of market participants), the unwinding of basis trades was likely not the primary cause of the stress observed in the U.S. Treasury Market during March 2020.68

C. The Commission Has Failed to Consider Reasonable Alternatives to the Proposed Rules That Could More Effectively Increase “Resiliency” and “Transparency” in the U.S. Treasury Market

28. While the Proposing Release focuses on designating private funds as government securities dealers to address the Commission’s concerns about “transparency” and “stability” in the U.S. Treasury Market,69 it fails to consider several reasonable, and potentially lower-cost alternatives, which include expanded central clearing and public dissemination of transactions reported to FINRA’s Trading Reporting and Compliance Engine (“TRACE”).

29. A potential alternative to mitigating some of the Commission’s concerns about leverage and stability would be to move the U.S. Treasury Market to clear through a central counterparty (“CCP”). A report from an interagency group on the March 2020 instability in the Treasury market (which included the Commission), found that “intermediation capacity did not keep pace with the demand for intermediation services amid the wave of sales of Treasury securities in March 2020”70 and acknowledged that “[c]entral clearing of Treasury securities transactions has been put forward as a way to reduce risk and increase intermediation capacity.”71 Clearing practices in the U.S. Treasury Market lag behind some other markets.72 While some parts of the U.S. Treasury Market are already centrally cleared,73 it is estimated that a majority of trades in the secondary U.S. Treasury Market still clear bilaterally, especially dealer-to-customer trades.74-75 As of 2017, only 13 percent of

68 Barth and Kahn (2021), Abstract (“While Treasury market disruptions spurred hedge funds to sell Treasuries, the unwinding of the basis trade was likely a consequence rather than the primary cause of the stress.”).
69 Proposing Release, p. 23054. See also p. 23088 (“the Commission believes that the Proposed Rules would support the stability and transparency of U.S. Treasury and other securities markets.”).
71 IAWG Report, p. 25.
73 IAWG Report, p. 29.
74 NY Fed TMPG White Paper, p. 5 (“There are two large segments of the secondary market for U.S. Treasury securities, dealer-to-customer trading and dealer-to-dealer trading, with the dealer-to-customer segment accounting for slightly more than half of secondary market trading.”).
75 See “DTCC Calls for More Central Clearing for U.S. Treasuries,” Markets Media, May 26, 2021 (“Today, the Federal Reserve estimates that up to 60% of outright purchases and sales of Treasuries through IDBs involve Principal Trading Firms (PTFs), who generally don’t participate in central clearing.”).
cash transactions were centrally cleared. Further, “[r]isk management practices for clearing and settlement of bilaterally cleared as well as centrally cleared trades may not have kept pace with market evolution.”

30. The implementation of central clearing would likely have a positive impact on market resiliency. As Federal Reserve Board Chairman Jerome Powell has observed, “in the right setting, central clearing can produce significant benefits, including reduced credit and liquidity risks; improved default management and reduced risk of fire sales; greater transparency; and improved risk management.”

Central clearing can help with the efficient posting of costly collateral, provide insurance against counterparty risk, and, maybe most relevant in this case, can mitigate fire sales. This last benefit is particularly relevant to the Commission’s concerns related to March 2020. For example, as noted in a study by the Depository Trust & Clearing Corporation, in a market with bilateral clearing “potential ‘fire sale’ risk may be unable to be mitigated in the event of a failed counterparty, wherein asset prices are driven down and contagion/stress could spread across the financial system.”

However, with centralized clearing, the CCP would manage a centralized liquidation of a failed counterparty’s portfolio in an orderly manner, which would help to avoid potential “fire sale” conditions. Given these benefits relevant to the issues raised in the Proposing Release, it is notable that the Commission does not mention central clearing in its economic analysis of the Proposing Release.

31. Another potential alternative to the proposed rules could be to require public dissemination of secondary market transactions in U.S. Treasury. The Commission’s general concern that the U.S. Treasury Market is opaque relative to other markets is not unfounded. I

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76 IAWG Report, p. 30 (“Overall, the Treasury Market Practices Group has estimated that 13 percent of cash transactions are centrally cleared; 68 percent are bilaterally cleared; and 19 percent involve hybrid clearing, in which one leg of a transaction on an IDB platform is centrally cleared and the other leg is bilaterally cleared.”);
77 NY Fed TMPG White Paper, p. 3.
79 Albert J. Menkveld and Guillaume Vuillemey, “The Economics of Central Clearing,” Annual Review of Financial Economics, 13, 2021, pp. 153–178 (“Menkveld and Vuillemey (2021)”) at p. 160 (“A last potential economic rationale for central clearing relates to the role of CCPs in mitigating fire sales. This mechanism aims to explain one feature of CCPs. Specifically, when a member defaults on its margin calls, the CCP does not liquidate this member’s position in the open market.”).
82 Additionally, centralized clearing through a CCP “can simplify data collection and improve visibility into market conditions for the authorities and … market participants,” another intended benefit of the proposed rule. See IAWG Report, p. 30.
understand that data collected through TRACE is only made public as weekly aggregated volume data, and does not provide any transparency into transaction level data.\textsuperscript{83} The proposed rules to designate private funds and PTFs as government securities dealers do nothing to address the market-wide need for more transparency, which could instead be addressed by providing publicly available TRACE reporting.

32. Studies of the corporate bond market, where TRACE reporting of over-the-counter transactions is mandatory, have demonstrated the benefits of public dissemination of transaction information, such as a positive impact on liquidity and reduced transaction costs.\textsuperscript{84, 85} This price transparency supports overall liquidity and market efficiency by removing information asymmetries, which helps to ensure that changes in supply/demand are efficiently reflected in current price levels.\textsuperscript{86} Despite its apparent benefits, the Proposing Release does not sufficiently consider whether public reporting requirements could achieve the objectives of the proposed rules at a lower cost to market participants. This is an obvious shortcoming of the economic analysis in the Proposing Release.

D. The Commission Has Failed to Consider All Costs Associated with the Proposed Rules

33. As noted in Section II, the Proposing Release acknowledges that there are costs that the Proposed Rules would impose on newly designated government securities dealers.\textsuperscript{87} The Commission specifically considers certain direct costs that would be imposed on the firms who are designated government securities dealers, including the “costs of registering with the Commission and with an SRO, recordkeeping and reporting costs, [and] direct costs that may stem from meeting net capital requirements.”\textsuperscript{88} However, the Commission’s analysis

\textsuperscript{83} IAWG Report, p. 27.
\textsuperscript{84} Michael A. Goldstein, Edith S. Hotchkiss, and Erik R. Sirri, “Transparency and Liquidity: A Controlled Experiment on Corporate Bonds,” \textit{The Review of Financial Studies}, 20(2), 2007, pp. 235–273 at p. 237 (“We find that depending on trade size, increased transparency has either a neutral or a positive effect on market liquidity, as measured by trading volume or estimated bid-ask spreads.”).
\textsuperscript{86} Henrik Bessembinder and William Maxwell, “Markets: Transparency and the Corporate Bond Market,” \textit{Journal of Economic Perspectives}, 22(2), 2008, pp. 217–234 at p. 232 (“In the presence of information asymmetries, less-informed traders will often be dissuaded from participating in a limit order market… TRACE likely increased traders’ willingness to submit electronic limit orders by allowing traders to choose limit prices with enhanced knowledge of market conditions. … Investors have benefited from the increased transparency through substantial reductions in the bid–ask spreads.”).
\textsuperscript{87} Proposing Release, p. 23078.
\textsuperscript{88} Proposing Release, p. 23089.
understates and mischaracterizes the overall costs associated with the proposed rules. First, it understates the total direct costs the proposed rules will impose on newly registered government securities dealers. Second, it fails to appropriately consider and account for the indirect (and economic) costs associated with certain requirements, such as the net capital requirements that would be imposed on the firms identified as government securities dealers. \textsuperscript{89}

34. First, the Commission’s list of new costs that will be imposed on firms that are forced to register as government securities dealers understates the associated direct costs, as there are other costly requirements that government securities dealers are subjected to that are not accounted for in the Proposing Release. For example, while hedge funds do not have customers, registration as a dealer would require a hedge fund to become a member of the Securities Investor Protection Corporation ("SIPC"), as “[a]ll registered brokers or dealers, by law, automatically become SIPC members.” \textsuperscript{90} SIPC membership entails known direct costs, such as the requirement to pay assessments into the SIPC Fund. \textsuperscript{91}

35. Even among the direct costs it does address, the Commission does not provide a consistent estimate of total cost. In the Proposing Release, the Commission “estimates compliance costs of approximately $600,000 initially and $265,000 annually thereafter to register as a broker-dealer with the Commission, become a member of an SRO, and comply with the associated dealer regulations.” \textsuperscript{92} However, it is clear from the Proposing Release that the actual figures may be much larger. For instance, FINRA imposes a “Gross Income Assessment” which charges a percentage of annual gross revenue. \textsuperscript{93} For firms with gross revenues of just under $500 million or above, the annual cost of FINRA membership alone would exceed the Commission’s $265,000 annual cost estimate. \textsuperscript{94} Larger firms could end up paying substantially more. \textsuperscript{95} Imposing such costs on newly designated government securities dealers.

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\textsuperscript{89} I discuss potential costs associated with the interaction of the proposed rules and other existing rules in Section V, including the possibility that both direct and indirect costs imposed on private funds through additional regulation could end up being passed through to investors.

\textsuperscript{90} See “Member FAQs,” \textit{SIPC}.

\textsuperscript{91} See “The SIPC Fund,” \textit{SIPC}.

\textsuperscript{92} Proposing Release, p. 23089.

\textsuperscript{93} Proposing Release, p. 23090, footnote 280.

\textsuperscript{94} Proposing Release, p. 23090, footnote 280. Estimation based on FINRA’s Gross Income Assessment. This does not include the costs of reporting trades to TRACE. See Proposing Release, p. 23089, footnote 271.

\textsuperscript{95} Specifically, FINRA’s Gross Income Assessment includes different charges for a firm’s gross revenues between $100 million and $5 billion, $5 and $25 billion, and greater than $25 billion. See Proposing Release, p. 23090, footnote 280.
dealers may provide an unnecessary barrier to entry that deters firms looking to participate in the U.S. Treasury Market and could ultimately harm market quality.\(^{96}\)

36. Second, in order to appropriately consider and account for all costs associated with the proposed rules, the Commission must also examine indirect costs imposed on newly designated dealers (to understand the full extent of economic costs being imposed). As an example, the Commission acknowledges that net capital requirements would mean that “newly registered dealers who previously held less capital than what is required would have to increase their capitalization either by raising equity or by scaling back trading activities.”\(^{97}\) However, the Commission does not provide any analysis or quantification of these costs, beyond speculating that the costs “may be partially offset by reductions in the firm’s cost of capital.”\(^{98}\) Other examples of indirect costs not examined by the Commission include legal costs associated with amending contractual agreements between private funds that are newly designated government securities dealers and their counterparties and vendors, with respect to whom they would now be differentially positioned and have potentially different obligations as new government securities dealers. By referencing its ability to evaluate “[w]hether or not a person is a ‘dealer’ … based on the facts and circumstances” outside of the proposed rules, the Commission introduces uncertainty and still more costs.\(^{99}\) According to the Commission, a firm could still be deemed a dealer even if it does not satisfy any of the qualitative or quantitative factors listed in the proposed rules. This possibility creates uncertainty for firms as to whether the Commission (or private plaintiffs) will later allege that the firms should have been registered as dealers, and creates costs associated with litigation risk (such as legal, compliance, and insurance costs). It is unclear whether firms would adjust their trading behavior to mitigate these risks.

37. Finally, even if the Commission’s analysis accurately listed and accounted for all the costs (both direct and indirect) associated with the proposed rules—which it does not—it would still not provide sufficient evidence to conclude affirmatively that the benefits of the proposed rules outweigh its costs. This is because the Commission has not attempted to quantify the benefits associated with the proposed rules, either for the market as a whole or

\(^{96}\) See Section IV.B for further discussion on potential impacts on market quality.

\(^{97}\) Proposing Release, p. 23090.

\(^{98}\) Proposing Release, p. 23090.

\(^{99}\) Proposing Release, p. 23059, footnote 51 (“Further, a person not meeting the standards in the Proposed Rules may still be a dealer under otherwise applicable dealer precedent. Whether or not a person is a ‘dealer’ is based on the facts and circumstances, where various factors are ‘neither exclusive, nor function as a checklist,’ and meeting any one factor may be sufficient to establish dealer status.”).
individual firms. As such, the Proposing Release’s statement that the Commission believes “that the benefits of registering [firms] who are also significant market participants justify the costs”\textsuperscript{100} is speculative and not based on any quantitative economic analysis of costs relative to benefits.

IV. The Commission Has Failed to Properly Consider the Impact of the Proposed Quantitative Threshold (and Likely Investor Responses to this Threshold) On Market Quality

38. In this Proposing Release, the Commission has failed to rigorously analyze the economic consequences of the proposed rules. The Commission asserts that its economic analysis supports the notion that the proposed rules will address the stability of the U.S. Treasury Market. However, the Commission’s economic analysis does not adequately consider how participants in this market will react to the proposed rules, and the impact their reactions will have on the U.S. Treasury Market and other markets. At a minimum, the Commission needs to perform additional analysis to address three issues. First, it should examine the extent to which market participants will adjust their activity in response to the quantitative standard, including potential withdrawal from the market or reduced activity. Second, it should examine the impact that the proposed rules may have in causing a withdrawal (or partial withdrawal) of market participants and the effect such a withdrawal would have on the quality of the U.S. Treasury Market. Finally, it should examine the interrelation between the U.S. Treasury Market and other markets and consider how the proposed rules will affect the relationships between these markets.

A. Academic Literature Has Shown that Imposing Thresholds for Registration May Impact Investor Behavior

39. Academic literature in policy-making and finance supports the notion that market participants adjust their behavior in response to regulation, especially if that regulation involves binary criteria, or so-called “cliffs” whereby regulatory consequences are triggered if a measure crosses a specific threshold. For example, Jank, Roling, and Smajlbegovic (2021) document how traders adjust their behavior in response to a binary disclosure threshold for short sales and short positions and show that traders accumulate positions just

\textsuperscript{100} Proposing Release, p. 23091.
below the applicable disclosure threshold to avoid disclosure, thereby hampering price discovery. Another example involves asset thresholds in bank regulation. Following the Great Recession, the Federal Reserve participated in a number of regulatory initiatives for enhanced supervision of the banking system that relied on bright-line asset thresholds, e.g. $10 billion, $50 billion, etc. However, research suggests that these bright-line thresholds have profound distortionary effects on the banking system. Specifically, data suggest that they can alter competition in the banking system, and steer the system towards further consolidation, as banks approaching thresholds “are motivated to merge, because they would prefer entering a more stringent regulatory regime with cost savings from a big jump in economies of scale to incrementally crossing the line.”

40. While the Commission acknowledges the risk that market participants might alter their trading in response to the proposed rules, it has not presented any analysis of relevant data in the Proposing Release. Indeed, the Proposing Release solicits feedback from market participants on whether “firms [would] be incentivized to trade below the proposed quantitative standard to avoid registration.” Thus, the Commission simply does not know whether the proposed volume threshold will lead market participants to curtail their activity to avoid crossing the threshold, or lead market participants to consolidate and scale up their activity in such a way that the compliance costs of the government securities dealers designation are offset against potential economies of scale in fund operations. These dramatically different outcomes can be expected to have different effects on trading volume, liquidity, and competition in the U.S. Treasury Market and related markets. Without conducting a proper study of the possible reaction of market participants to the proposed rules, the Commission cannot understand the likely economic consequences of the proposed rules with respect to U.S. Treasury Market quality.


103 Proposing Release, p. 23073 (“Are there circumstances in which a person triggering the quantitative threshold would not also trigger the proposed qualitative standards? Please describe those circumstances in detail. In such case, would firms implement compliance systems to monitor trading volumes? Do firms have systems in place that already or could easily be programmed to monitor for the proposed quantitative threshold? What are the costs of implementing such systems or updating existing systems? Would firms be incentivized to trade below the proposed quantitative standard to avoid registration?”).
41. The Commission’s failure to analyze data in the Proposing Release constrains the Commission’s ability to issue a final rule. Principles of sound economic analysis (along with the Administrative Procedure Act) require the Commission to expose any new data or analysis to public comment before finalizing a proposal.

B. Changes in Investor Behavior as a Result of the Proposed Rules Could Harm Market Quality in the U.S. Treasury Market

42. One way that market quality in the U.S. Treasury Market could be harmed is if the constraints of the proposed rules curtail activity that is currently beneficial to market quality. Indeed, as the Commission acknowledges, the proposed rules “may influence patterns of market participation, which may in turn affect competition among liquidity providers, market efficiency, and capital formation.” According to the Inter-Agency Working Group on Treasury Market Surveillance, an example of this behavior is the change in capital allocation of banks and bank-affiliated broker-dealers away from intermediation in the U.S. Treasury Market towards activities with relatively higher profit margins, following the implementation of new capital requirements in the wake of the global financial crisis. However, the Commission appears to ignore the very real possibility that market participants may modify their trading behavior in response to the proposed rules. It asserts instead, without providing any support other than its staff’s “understanding,” that “[a]ny net effect on competition would likely be small…because liquidity provision in securities markets is reasonably competitive even among currently registered dealers.”

43. A study is necessary to determine the likely economic consequences of the proposed rules on competition and features of market quality, such as liquidity, stability, and competition within the U.S. Treasury Market. Such a study should at a minimum assess the likely impact of a potential withdrawal or curtailment of investment, trading, and hedging activity by affected market participants if the proposed rules were to be implemented on the liquidity and stability of the cash Treasury market in stress scenarios. As it currently stands,

104 Chamber of Commerce v. SEC, 443 F.3d 890, 899 (D.C. Cir. 2006) (“Among the information that must be revealed for public evaluation are the ‘technical studies and data’ upon which the agency relies.”).
105 Proposing Release, p. 23088.
106 Proposing Release, p. 23091.
107 IAWG Report, p. 5. The report notes that “[e]ven when the demand for intermediation in the Treasury market has spiked and potential profits from intermediation have risen, banks and bank-affiliated broker-dealers sometimes have not meaningfully expanded their balance sheets in aggregate to meet the increase in demand.”
the Commission is asserting that the proposed rules are necessary to prevent the withdrawal
(via risk of failure or failure) of a supposed liquidity provider, because such a withdrawal
could significantly impair liquidity and market stability.109 At the same time, however, the
Commission asserts that the withdrawal of a supposed liquidity provider from the market
entirely as a result of the requirements of the proposed rules would have an insignificant
impact. A formal study is necessary for the Commission to determine what the likely
magnitude of the effect will be if market participants curtail their activities or withdraw from
participating in the market as a result of complying with the requirements of the proposed
rules. For example, as discussed in Section III.B, the Commission has not considered
whether the proposed rules would provide a competitive advantage to foreign firms relative
to U.S. firms that might position foreign firms to fill the void as some U.S. firms withdraw
from the U.S. Treasury Market.

C. The Commission Has Not Sufficiently Considered How the Proposed
   Rules May Impact Related Markets

44. The Commission also fails to consider the impact of the proposed rules on other
markets closely connected to the U.S. Treasury Market, for example by arbitrage principles,
such as the U.S. Treasury futures market. A study is needed to characterize the proposed
rules’ implications for the U.S. Treasury futures market, and the cash-futures relationship.
45. The Proposing Release acknowledges that market participants, such as hedge funds,
do not just trade in the cash market, but also in the Treasury futures market. In particular,
one cited study estimates that 65 percent of hedge funds’ total Treasury exposure was tied to
a basis trade strategy, which involves taking offsetting positions in the Treasury cash and
futures markets, and profiting from the eventual convergence of the cash and futures prices
ward the delivery date.110 Usually, the strategy consists of a long Treasury position in the
cheapest-to-deliver bond, financed through the repo market, and a short leg in the Treasury
futures contract.111 The Commission should examine the impact of the proposed rules on the
economics of the Treasury basis trade strategy. Even though the Treasury futures side of
basis trades would not count towards the quantitative threshold (since futures are not

109 Proposing Release, p. 23086 (“Since, as discussed above, losses on the part of one market participant can
harm others, dealer regulations are designed to mitigate the magnitude of these externalities and to reduce the
probability that they occur at all.”).
110 Proposing Release, p. 23082. See also Barth and Kahn (2021).
securities), it is likely that the proposed rules would still impact the economics of the trading strategy (by liquidity effects in the cash market for example). The Commission should therefore examine the implications of a withdrawal of hedge funds from the Treasury futures market.

46. In a similar vein, the Commission should consider investment funds’ role in the Treasury auctions. Investment funds, including hedge funds, have approximately a 50% market share in Treasury auctions (see figure below).\[112\] If the proposed rules affect the economics of other aspects of funds’ Treasury strategies, it is likely that the proposed rules will also affect their appetite for bidding in the Treasury auctions. This may affect the cost of borrowing for the U.S. government. These are first-order considerations that the Commission should examine using data-driven economic analysis.

### Treasury Market Auction Participation by Investor Class\[1\]

<table>
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<th>Year[2]</th>
<th>Total Issue</th>
<th>(SOMA) Federal Reserve Banks</th>
<th>Dealers and Brokers</th>
<th>Investment Funds</th>
<th>Foreign and International</th>
<th>Other</th>
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<tbody>
<tr>
<td>2022 YTD</td>
<td>1,500</td>
<td>17%</td>
<td>17%</td>
<td>49%</td>
<td>16%</td>
<td>1%</td>
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<tr>
<td>2020</td>
<td>3,896</td>
<td>12%</td>
<td>28%</td>
<td>45%</td>
<td>13%</td>
<td>2%</td>
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<td>2,935</td>
<td>8%</td>
<td>28%</td>
<td>51%</td>
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<td>1%</td>
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<td>33%</td>
<td>44%</td>
<td>13%</td>
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<td>30%</td>
<td>45%</td>
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<td>2016</td>
<td>2,169</td>
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<td>3%</td>
<td>53%</td>
<td>19%</td>
<td>23%</td>
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Source: US Treasury Department

Note:
1. Figures reflect allotment by investor class for marketable Treasury coupon auctions. Total issue shown in billions USD. Other values calculated as volume divided by total issue.
2. YTD as of 5/9/2022.

V. The Commission Fails to Jointly Consider the Possible Impact of Other Proposed Rules with Potentially Similar Indirect Costs

47. While the Proposing Release includes a discussion of potential costs associated with the proposed rules, the Commission fails to comprehensively consider the potential unintended effects that may occur from the interaction costs resulting from the full slate of rules, including the ones discussed herein, being issued simultaneously (i.e., “knock-on effects”). In simultaneous rulemakings, the Commission is proposing several rules that will

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directly impact either private funds or the markets in which these funds operate.\textsuperscript{113} The Commission cannot consider these rules in isolation because of the potential costs of regulatory accumulation, the many forms of which Mandel and Carew (2013) define.\textsuperscript{114}

48. One type of regulatory accumulation is the interaction between regulations, in which “[m]ultiple regulations can interact in obvious or non-obvious ways that raise costs for businesses.”\textsuperscript{115} For example, the Proposing Release acknowledges that, in response to the proposed rules, hedge funds may “permanently reduce their [U.S. Treasury] market activity or their pursuit of certain investment strategies”\textsuperscript{116} which would likely have some impact on the returns generated by the hedge funds. Yet, the Commission does not consider the potential impact on hedge fund returns of any of the proposed rules in the context of other proposed rules that may also impact hedge fund returns, such as the Proposing Release for the Private Funds Rule. In that proposing release, the Commission acknowledged that the required restructuring of funds using a pass-through expense model could “divert[] the hedge fund’s resources away from the hedge fund’s investment strategy” and “lead to a lower return to investors in hedge funds.”\textsuperscript{117} Therefore, a hedge fund that uses a pass through expense model may have its returns reduced by multiple proposed rules, which the Commission has not considered nor quantified in either of the individual proposing releases.

49. Further, by only considering these proposed rules in isolation, the Commission is not providing a comprehensive picture of compliance costs and other direct costs. For example, the Proposing Release acknowledges that the proposed rules will impose costs on certain private funds such as the “costs of registering with the Commission and with an SRO, recordkeeping and reporting costs, [and] direct costs that may stem from meeting net capital


\textsuperscript{115} Mandel and Carew (2013), p. 3.

\textsuperscript{116} Proposing Release, p. 23091.

requirements.”118 However, such direct costs associated with registering as a government securities dealers will aggregate with the direct costs of compliance with other proposed rules which impact that fund. These costs must be considered jointly, and in the context of the direct costs of the other proposed rules discussed above.

50. Finally, the Commission has not analyzed or quantified the extent to which investors in private funds will ultimately bear the costs—both the direct costs of compliance and the indirect costs in the form of lower returns—caused by its proposed rules. The Proposing Release acknowledges that costs to private funds may be “passed on to the funds’ investors,”119 but the Commission does not attempt to quantify the impact that these proposed rules will have on fund investors, let alone the aggregate impact all its proposed rules affecting private funds will have.

Respectfully submitted,

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118 Proposing Release, p. 23089.
119 Proposing Release, p. 23091.