STANFORD GRADUATE SCHOOL OF BUSINESS, STANFORD UNIVERSITY
655 KNIGHT WAY, STANFORD, CALIFORNIA 94305-7298 USA

J. DARRELL DUFFIE
THE ADAMS DISTINGUISHED
PROFESSOR OF MANAGEMENT AND PROFESSOR OF FINANCE

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Via Electronic Mail: rule-comments@sec.gov

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

Regarding: Notice of Proposed Rulemaking on Further Definition of "As a Part of a Regular Business" in the Definition of Dealer and Government Securities Dealer, File No. S7-12-22

Dear Ms. Countryman:

This letter is a comment to the Securities and Exchange Commission (SEC) on its proposed rulemaking to further define the terms "government securities dealer" in Section 3(a)(44) of the Securities Exchange Act of 1934.

I have no affiliation with an affected firm nor any financial compensation related to this matter.

In general, I support increasing the stability and transparency of the government securities market by changing the definition of "government securities dealer" along the lines of the proposed rulemaking. However, the proposed quantitative threshold of trading activity, as a sufficient criterion on its own, seems inappropriate. The requirement to register as a dealer should be based on the nature of trading activities, which need not be entirely determined by amounts traded. That issue has already been well aired by other commenters and I won't dwell on it here.

I write instead mainly out of concern over the potential adverse implications for Treasury market liquidity of the proposed rulemaking in combination with one part of the capital requirements for registered government securities dealers, Securities and Exchange Act Rule 15c3-1(c)(2)(i)(G)(2), which states[1] that

"Any withdrawal of capital made within one year of its contribution is deemed to have been intended to be withdrawn within a period of one year, unless the withdrawal has been approved in writing by the Examining Authority for the broker or dealer."

[1] See **NET CAPITAL REQUIREMENTS FOR BROKERS OR DEALERS: SEA Rule 15c3-1.**

In combination with other parts of Rule 15c3-1(c)(2)(i)(G), this apparently implies that a capital contribution will not count toward a dealer's regulatory definition of capital if the contributed capital is withdrawn within a year of its contribution. Similarly, FINRA Rule 4110 states, under item (c)(1),

"No equity capital of a member may be withdrawn for a period of one year from the date such equity capital is contributed, unless otherwise permitted by FINRA in writing. Subject to the requirements of paragraph (c)(2) of this Rule, this paragraph shall not preclude a member from withdrawing profits earned."

Please allow me to suggest why these "capital-lockup" rules may have an adverse impact on Treasury market liquidity and potentially exacerbate episodes of market dysfunction, which could become more frequent and severe given the burgeoning size of the Treasury market relative to the intermediation capacity of the market.[2]

Some firms that would likely be required to register as government securities dealers under the proposed rulemaking rely for capital contributions on owners that have other trading businesses. Such a "parent" firm has the option to contribute capital to any of its trading businesses, which I will call "subsidiaries." The parent can make these capital contributions opportunistically, whenever market conditions suggest that expected returns are higher, relative to risk, in one trading subsidiary in comparison with another. If, however, a subsidiary that trades government securities becomes registered as a government securities dealer, then capital that is downstreamed to that subsidiary must remain in that subsidiary for at least one year, to the extent that the capital contribution is necessary to meet the dealer's regulatory capital requirements at any point in time during that year. Thus, to make efficient use of the parent firm's capital, the parent will choose to trap less of its capital in its government securities dealer subsidiary than it would in a non-dealer subsidiary with similar risk-and-return opportunities. As a result, when US Treasury market liquidity deteriorates, as during the COVID shock of March of 2020, we would expect less capital to be committed to the US Treasury market by some firms that must newly register as government securities dealers under the proposed rulemaking than would be the case if those firms were not to register as government securities dealers.

As a simplified illustrative example, suppose a parent firm has subsidiary firms A and B that trade in markets A and B, respectively. Suppose firms A and B are not regulated as dealers. The parent has $100 million of available discretionary capital to deploy in either of its subsidiary businesses. Suppose that in March of a given year, a disruption in market A presents a significant profit opportunity for firm A. The parent firm therefore downstreams its $100 million of available discretionary capital to firm A to backstop risky new positions. By April, conditions in market A return to normal, the positions that were added in March are liquidated, and $100 million of capital is withdrawn from firm A by the parent. Then, in June, an opportunity for deploying capital in market B arises, at which point the parent downstreams $100 million to firm B. Had firm A been subject to the capital-lockup rule that I described, however, this efficient approach to deploying parent capital would not be possible because the $100 million March

[2] See "Resilience Redux in the U.S. Treasury Market," Darrell Duffie, Jackson Hole Symposium Paper, Federal Reserve Bank of Kansas, August, 2023, and "Dealer Capacity and US Treasury Market Functionality," by Darrell Duffie, Michael Fleming, Frank Keane, Claire Nelson, Or Shachar, and Peter Van Tassel, Staff Report 1070, Federal Reserve Bank of New York, October, 2023.

capital contribution to firm A would not count toward the regulatory definition of capital for firm A. Aware of this in March, perhaps the parent would have downstreamed only, say, $40 million of capital to firm A, leaving $60 million of discretionary parent capital available to address new profit opportunities for firms A and B at later points in time over the subsequent year. This reduced incentive to commit capital to firm A is exacerbated to the extent that the parent firm has more than two such subsidiaries.

If an important set of participants in government securities markets are affected by the proposed rulemaking in combination with the one-year capital-lockup effect that I described, then the mobility of capital into US government securities markets could be significantly dampened. When the government securities market is experiencing excessively low liquidity, flows of capital into the market that could improve liquidity may be inefficiently held back, with a likely adverse impact on market liquidity. Moreover, capital formation at the parent level would probably be reduced, given the loss of efficiency with which capital could be deployed across multiple trading subsidiaries.

Along with its proposed rulemaking regarding the definition of a government securities dealer, the Commission may wish to consider an amendment to the capital requirements of government securities dealers that allows capital contributions to count toward the definition of regulatory capital even if withdrawn within a much shorter period of time than one year, provided that the firm meets all other capital requirements. To maintain financial stability and protect investors, it is critical that dealing firms are well capitalized at all times, but I don't see a good case for requiring contributions of capital to remain in the dealer long after they are needed to buffer actual risks to the solvency of the dealer.

I appreciate the opportunity to comment on your proposed rulemaking. Please feel free to contact me if the Commission or its staff have any questions.

Sincerely,

Darrell Duffie

Darrell Duffie