ES161831

Congress of the United States
Washington, DC 20515

February 9, 2023

The Honorable Gary Gensler
Chair
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-0100

Dear Chair Gensler,

The U.S. Treasury market is understood to be the deepest and most liquid government securities market in the world. It plays a central role in both the U.S. and global economies, finances the federal government, provides a safe and liquid asset, and facilitates the implementation of monetary policy. In its latest Financial Stability Report, however, the Federal Reserve observed that the Treasury market is experiencing liquidity strains and, for some securities, a reduction in market depth that is approaching levels seen during the onset of the COVID-19 pandemic.[1]

This deterioration in liquidity has not gone unnoticed. Indeed, Treasury Secretary Janet Yellen, among others, has voiced her and the Department's concerns regarding this trend.[2] Accordingly, it is critical that the Securities and Exchange Commission (the "Commission") carefully consider its role in preventing any further harm to the Treasury market, and instead pursue initiatives that bolster its vibrancy and enhance liquidity. We are concerned, however, that the Commission's proposed rule to amend the definition of "government securities dealer" (the "Proposal" or "Proposed Rules")[3] will only exacerbate this recent and ongoing trend.

The Proposal would require a market participant to register as a government securities dealer if one of three qualitative standards are implicated or one quantitative standard is met.[4] As the Commission notes, registration and regulation as a dealer or government securities dealer comes with quantifiable costs,[5] but, in this case, the actual costs to both market participants and the market itself of forcing private funds that are investors to become dealers or change their trading behavior are likely to be extraordinary and exceed the perceived benefits of the Proposal. Moreover, the broad qualitative and quantitative dealer tests the Commission proposes exceed the scope of the statutory definitions of dealer and government securities dealer.[6]

---

1 Financial Stability Report, Board of Governors of the Federal Reserve System (Nov. 4, 2022), *available at* https://www.federalreserve.gov/publications/files/financial-stability-report-20221104.pdf.

2 *See e.g.,* Janet Yellen, "Remarks by Secretary of the Treasury Janet L. Yellen at the Securities Industry and Financial Markets Association's Annual Meeting" (Oct. 24, 2022), *available at* https://home.treasury.gov/news/press-releases/jy1045; Chris Anstey, *Yellen Worries Over Loss of 'Adequate Liquidity in Treasuries'*, Bloomberg (Oct. 12, 2022), *available at* https://www.bloomberg.com/news/articles/2022-10-12/yellen-worries-over-loss-of-adequate-liquidity-in-treasuries.

3 SEC, Proposing Release, Further Definition of "As a Part of a Regular Business" in the Definition of Dealer and Government Securities Dealer, 87 Fed. Reg. 23054 (April 18, 2022) (the "Proposing Release").

4 Buying and selling more than $25 billion in government securities in each of four out of the last six calendar months. *Id.* at 23071.

5 *Id.* at 23089-90.

6 *See* Securities Exchange Act of 1934 Sections 3(a)(5) and 3(a)(44).

Given the overbreadth of the Proposed Rules, many private funds engaged in a wide range of trading strategies (who are typically themselves customers of registered broker-dealers) would be captured by the Proposal despite the fact that such activity is not indicative of "dealing activity" and the lack of clear benefit and the enormous market impact of this decision. Indeed, the Commission concludes that in registering private funds as dealers "the marginal benefits of other reporting requirements, net capital requirements, book and records rules, and examinations might be very small, since the regulatory regime that applies to registered private fund advisers already contains similar provisions to the rules that apply to dealers."[7] The Commission also concludes that treating investment companies registered under the Investment Company Act of 1940 ("RICs") as dealers "would also lead to significant costs and uncertainty."[8] The Proposal highlights the fact that, for example, "it is unclear how [RICs] would comply with net capital requirements, or how they would define net capital."[9]

Similar considerations apply to private funds. The Proposal does not articulate how the dealer regulatory framework would apply to private funds, as it assumes that a private fund's existing organizational and operational structure will fit neatly within this separate regulatory regime. However, private funds, like RICs, are investment funds that share the same characteristic and business purpose in that they are pools of capital most often directed by an external entity. The same costs and uncertainty of application of the various dealer-related obligations mentioned in the Proposal associated with RICs will also apply to private funds.

If faced with dealer registration, private funds have told us they will change or abandon certain investment or trading strategies, particularly in the face of the arbitrary and untested bright-line threshold for activity in U.S. Treasury securities. We understand that this likelihood would not just be due to the monetary costs involved but the incompatibility of the dealer regulatory framework for vehicles that pool investor capital like private funds, which are not established or intended to be operating companies. In addition, because private funds will lose significant customer protections when they have to register as dealers, it is inevitable that their investors will be unwilling to take on additional risks associated with reduced customer asset segregation under SEC Rule 15c3-3[10] and the various FINRA and SEC sales practice protections.[11] The potential increase in regulatory compliance costs and investor risk, as well as the fundamental change in the nature of the investment product would lead to investors divesting from certain private funds, and by extension, a reduction in the private sector capital allocated to participating in the U.S. Treasury market.

---

7 *Id.* at 23088.
8 *Id.* at 23094.
9 *Id.*
10 17 CFR § 240.15c3-3 - Customer protection - reserves and custody of securities.
11 *See e.g.,* FINRA Rule 2111 (Suitability), FINRA Rule 2121 (Fair Prices and Commissions); FINRA Rule 2231 (Customer Account Statements); FINRA Rule 2232 (Customer Confirmations); FINRA Rule 5130 (Restrictions on the Purchase and Sale of Initial Equity Public Offerings); FINRA Rule 5310 (Best Execution and Interpositioning); and FINRA Rule 5320 (Prohibition Against Trading Ahead of Customer Orders).

Given that the Commission acknowledges that private funds play an important role (which is not equivalent to dealing activity) in the U.S. Treasury and equity markets and the structural incompatibilities of the asset management model with its dual structure centered around investment advisers and managed funds, we are concerned that a simple application of the dealer regime to these entities will prove counterproductive. This reduction in liquidity and competition would harm the fund, its investors and advisers, other market participants, and markets generally. The U.S. Treasury market particularly cannot afford a further decline in liquidity, consolidation of market participants or impaired efficiency. The liquidity and depth of our markets have helped establish them as the center of the global financial system, affording countless benefits to Americans. Given the potential negative impacts of the Proposal, we respectfully request your timely response to the following questions:

- Why did the Commission include private funds within the scope of the Proposal when private funds and their investment advisers are subject to an extensive regulatory framework, particularly when the Proposal acknowledges that the benefits of registering private funds as dealers "might be very small" and the likely negative impact on liquidity in the U.S. Treasury market if private funds exit the market or curtail their trading activity to avoid dealer registration?

- How does the Commission envision private funds and their investment advisers to register as dealers and comply with the dealer regulatory framework? For example, how would the Net Capital Rule apply to private funds, particularly given the typical redemption rights that are essential to the operation of private funds? What would the impact be on investors of private funds? For example, what's the cost-benefit for an investor to be invested in a broker-dealer instead of a private fund?

- Did the Commission consider other data sources, beyond TRACE data, to estimate the number of market participants that would be captured by either the quantitative standard or the qualitative standard? Does the Commission recognize that it significantly understates the number of entities that would be captured by the Proposal?

- Why did the Commission choose to not estimate the Proposal's costs on market efficiency, competition, and capital formation, instead labeling them "uncertain"?[12] Does the Commission intend to include such an estimate of the costs associated with the Proposal in the final rule, particularly the costs associated with the negative effect on the liquidity in the U.S. Treasury market that is likely to arise if private funds exit the market or curtail their trading activity?

---

[12] Proposing Release, *supra* note 2, at 23091-92.

Congress of the United States
Washington, DC 20515

We appreciate your prompt attention to our concerns and timely response to the questions listed above.

Sincerely,

Bill Hagerty
United States Senator

French Hill
Member of Congress

cc: The Honorable Janet Yellen, Secretary, Department of Treasury