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November 23, 2004

Ms. Lori Santamorena  
Executive Director  
Bureau of the Public Debt,  
Government Securities Regulations Staff  
799 9<sup>th</sup> Street NW  
Washington, DC 20239-0001

**Re: Docket No. BPD GSRS 04-01.**

The Bond Market Association<sup>1</sup> ("Association") and its Primary Dealers Committee<sup>2</sup> appreciate the opportunity to comment to the Bureau of Public Debt ("Bureau") on the rule proposal<sup>3</sup> ("Rule Proposal") recently issued by the Treasury Department ("Treasury") to amend 31 CFR Part 356 (Uniform Offering Circular for the Sale and Issue of Marketable Book-Entry Treasury Bills, Notes, and Bonds) (the "UOC")<sup>4</sup> to allow the exclusion of certain affiliations arising from investment activities when determining the group of affiliated entities that will be deemed a single bidder for purposes of the Treasury's auction rules. The amendment proposes that certain business relationships between two entities that would currently be treated as a single bidder under the auction rules to be treated as separate bidders. Specifically, the proposed amendment states that an entity that is more than 50-percent-owned by a corporation or partnership is not deemed to be an affiliate of the corporation or partnership if the ownership is for investment purposes only.

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<sup>1</sup> The Association represents securities firms and banks that underwrite, distribute and trade in fixed income securities, both domestically and internationally, including all primary dealers recognized by the Federal Reserve Bank of New York. Our members are also actively involved in the funding markets for such securities, including the repurchase and securities lending markets. Further information regarding the Association, its members, and activities, can be obtained from our public website <http://www.bondmarkets.com>.

<sup>2</sup> The Primary Dealers Committee is made up of senior representatives from the primary dealers in United States government securities whose name appears on the "List of the Government Securities Dealers Reporting to the Market Reports Division of the Federal Reserve Bank of New York" and inter-dealer brokers who serve as conduits between Primary dealers in the Treasury and federal agency securities markets.

<sup>3</sup> See 69 Fed. Reg. 54251 (Sept. 8, 2004).

<sup>4</sup> See 69 Fed. Reg. 45202 (July 28, 2004).

## **1. Executive Summary**

### **1.1. The Association Fully Supports the Rule Proposal.**

The Association fully supports the overall objectives and rationale underlying the Rule Proposal. Many of the large financial services firms that bid in your auctions have affiliates that are directly or indirectly involved in so-called “merchant banking activities” including private equity investments. These relationships pose little risk that the bidder would act in concert with such investment entities regarding transactions in, and holdings of, Treasury securities. Allowing bidders to exclude such activities from a corporate or partnership structure when calculating their net long position (“NLP”), therefore, makes practical sense. This is especially true given the operational difficulties of receiving information or certifications from each investment affiliate before each auction and combining such information with the bidders overall NLP number only thirty (30) minutes before the auction.

### **1.2. One Aspect of the Proposed Certification is Overly Broad**

The Association believes the required certification is overly broad given the purpose of the rule. The Rule Proposal would require a bidder to make three certifications regarding any qualifying investment of which it owns more than 50 percent. We feel strongly that the first of these certifications should focus more narrowly on prohibiting the bidder or its other affiliates from making operational or investment decisions for the entity.

## **2. Discussion**

### **2.1. Growth of Private Equity & Merchant Banking Investment Relationships**

The Association applauds Treasury for recognizing that many Primary Dealers and other firms that are frequent auction participants also sometimes engage directly or through affiliates in merchant banking investments. Merchant banking activities of financial institutions also include participation in, and sponsorship of, private equity funds. These activities are an important source of growth-oriented capital to the U.S. economy. Such investments also provide an important means by which firms diversify their risks and seek added value for shareholders.

While the range of private investment activity covered by the Rule Proposal should be broader than those permitted for financial holding companies under the Graham-Leach-Bliley Act of 1999 (“GLBA”), Congress’ experience in crafting the GLBA is conceptually instructive. In enacting the GLBA, Congress grappled with the fact many securities firms that might wish to acquire a bank holding company (and

thereby become a Federal Reserve regulated financial holding company (“FHC”)), could not engage in such mergers because they had some potentially non-permissible investments in commercial firms that they would be unwilling or unable to sell.

Since the GLBA was intended to facilitate broader affiliations between banks, securities firms and insurance companies while also recognizing the important role private equity funds and direct investments play in modern capital markets, Congress ultimately elected to allow some commercial (i.e. non-financial) activities and investments by FHCs. Thus, Congress authorized so-called merchant banking activities and investments in private equity funds by amending section 4(k)(4)(H) of the Bank Holding Company Act. Today, these activities remain a key source for capital for funding new and innovative businesses.<sup>5 6</sup> The chart attached as Appendix A illustrates the growing role of private equity and other alternative investment strategies in the global economy. Therefore, it is important that Treasury’s auction rules related to merchant banking and private equity investments be crafted in a manner that reflects a balanced and realistic approach to the compliance costs faced by bidders while ensuring the continued integrity of the auction process.

## **2.2. The Association Supports the Rule Proposal: the Activities of Affiliates in Which the Bidder Invests for Return Should Not be Included in a Bidder’s NLP Calculation.**

The Association fully supports the objective of the Rule Proposal because it makes the administrative burden of complying with the NLP reporting requirements much more reasonable for firms that engage in merchant banking or private equity investment activities.

Primary Dealers and other broker/dealers bidding in Treasury auctions are frequently affiliates of a larger, more complex international banking or financial services organization that includes U.S. and non-U.S. affiliates engaged in merchant banking activities. Because such activities can include the acquisition of a 50-percent or greater stake in commercial enterprises they do not manage on day-to-day basis, Primary Dealers and other large bidders can face issues that make compliance with the current NLP calculation and reporting requirements impractical. As the Rule Proposal correctly notes, the purpose of these investments is not to actually engage in the business of the enterprise, but rather to seek a reasonable return on investment. The problem is that as part of their day-to-day business these investments may, on occasion, purchase and hold Treasury securities without the knowledge of the Primary Dealer or its other non-merchant banking affiliates. In theory a Primary

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<sup>5</sup> From 1995 to 2004 the number of private equity firms in the U.S. has nearly doubled, while globally they have nearly tripled. See Appendix A.

<sup>6</sup> While it’s important to note that private equity firms are not synonymous with merchant banking activities, it is equally true that they raise the same auction issues since firms can own 50 percent of private equity partnerships and/or have executives on the boards of portfolio companies.

Dealer or other bidder is supposed to contact any and all affiliates to find out if they currently have any positions in the security being auctioned. It is then supposed to incorporate any reported holdings in the auctioned security by merchant banking and private equity investments in the NLP number it reports thirty minutes prior to the close of a Treasury auction.

This can be impractical for several reasons. First and foremost, given that these investment entities are not connected to any of the position management or financial reporting systems of the bidder, and that the bidder lacks day-to-day operational control over the investment, the bidder can't mandate that certain systems or procedures be in place in every entity where it holds a greater than 50 percent stake. As a result, the bidder can be in the situation where it can't obtain the information it needs to properly and timely report its total global direct and indirect holdings in the security being auctioned. Second, many of the financial institutions that own a Primary Dealer are headquartered outside of the United States and all of the most active bidders in Treasury auctions have substantial non-U.S. affiliates. This phenomenon makes it increasingly difficult for Primary Dealers to put in place procedures for obtaining accurate and timely information on the U.S. Treasury holdings of commercial affiliates recently acquired via private equity or merchant banking investments. Finally, since such commercial affiliates are generally not engaged in the securities business and either do not participate in Treasury securities auctions or rarely, if ever, hold material amounts of Treasury securities, the reportable positions of these affiliates is frequently zero or quite small. Therefore, investing in the personnel, compliance and systems infrastructure necessary to obtain, verify, and calculate the Treasury holdings of such investment-related affiliates as of one-half hour before an auction is unduly burdensome.

### **2.3. Bidders Should be Able to File A Simple Notification with Treasury Deeming Certain Entities as Excluded from the Definition of an Affiliate**

The Association agrees that the public interest is best served by allowing deemed exclusion of private equity investments and merchant-banking type activities from a corporate or partnership structure (a "Deemed Non-Affiliate"). The Association also believes that receipt by Treasury of a written notice containing certain certifications should be sufficient to exclude such investments from the bidder's NLP calculation.

The purpose of the NLP reporting requirements is to help ensure the integrity and fairness of the auction process. By having large bidders report their NLP, Treasury can prevent a single bidder from receiving directly or indirectly an excessive amount of the securities sold at any of its auctions. While a bidder is only required to report their NLP when the total of all of its bids in an auction plus its NLP in the security being auctioned equals or exceeds the NLP reporting threshold for such auction (usually 35 percent of the offering amount), many Primary Dealers and other bidders have policies and procedures in place that require them to calculate and report their NLP in every auction in which they participate (i.e. regardless of the reporting threshold).

As noted above, given the nature of these investments, it can often be difficult and burdensome for some firms to fully comply with Treasury's NLP reporting requirements. Because, as Treasury had observed "entities acquired through merchant banking activities pose much less potential for acting in concert with their acquiring corporation or partnership in regard to transactions in, and holding of, Treasury securities,"<sup>7</sup> we think the proposed methodology for obtaining an exemption is reasonable.

**2.4. The Association Generally Agrees with the Proposed Criteria Under Which a 50-Percent Owned Entity Can be Excluded From the Definition of an Affiliate.**

The Association agrees that the notification received by Treasury should contain certain certifications. As you know, the Rule Proposal suggests that a notification seeking to exclude a corporation or partnership from the definition of an affiliate must contain the following four representations:

- The purpose of the ownership is to seek a return on investment and not to engage in the business of the entity;
- The bidder does not exercise any control over or make operational or investment decisions for the entity;
- The bidder has written policies or procedures, including ongoing compliance monitoring processes, that are designed to prevent the corporation from acting together with the entity regarding participation in Treasury auctions or investment strategies regarding Treasury securities being auctioned; and
- The bidder will continue to meet the terms of this certification until the bidder notifies the Treasury of such change.

We believe that it is reasonable for a bidder to be required to certify that the purpose of their ownership is to seek a return on investment and not to engage in the business of the entity. Such a representation helps ensure that the bidder is not routinely managing or operating the affiliate. We also agree that the bidder should certify that it has written policies, procedures and compliance monitoring processes in place designed to prevent the bidder from acting in concert with the investment regarding participation in Treasury auctions. Requiring that such procedures be in place is appropriate, as it will help ensure that all employees understand that any communication with any employees of the investment regarding the Treasury auction is strictly limited. Lastly, we support a requirement that a bidder commit to continuing to meet the terms of its certification until such time the bidder notifies the Treasury otherwise.

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<sup>7</sup> See 69 Fed. Reg. 54252 (Sept. 8, 2004).

However, as explained below, we do not believe that a general certification regarding exercise of control over or making operational or investment decisions for the investment is necessary or justifiable.

**2.5. The Proposed Certification Regarding Exercise of Control Over & Making Operational or Investment Decisions is Broader than Needed to Accomplish Treasury's Objectives.**

The Association is concerned with the language contained in the required certification that states that "the bidder does not exercise *any* control over or make operational or investment decisions for the entity (emphasis added)."<sup>8</sup> This certification should be amended. The purpose of the certification is a narrow one. It is intended to ensure that any interaction between a bidder and a Deemed Non-Affiliate will in no way allow the two entities to act in concert with respect to a Treasury auction.

One option would be to eliminate this particular representation altogether. Even without this representation, it is extremely unlikely that a bidder would act in concert with a merchant banking or private equity investment. First, the bidder is already being required to certify that the purpose of its investment is to seek a return on investment and not to engage in the business of the entity. Second, the bidder is also being required to separately certify that it has written policies and procedures in place that are designed to prevent it from "acting together with the entity regarding participation in Treasury auctions or investment strategies regarding Treasury securities being auctioned."<sup>9</sup> The proposed additional certification requirement is therefore arguably unnecessary.

**2.6. If a Representation Related to Operational & Investment Decisions of the Affiliate Must Be Preserved, It Should be Narrowed Substantially**

Another option would be to replace the second bullet point with a more targeted certification. If this approach is chosen, we recommend that the certification be modified as follows or in a similar manner:

"we do not make routine operational or investment decisions for the entity."

We are recommending this modification for several reasons. First, certification should not be focused on preventing the exercise of control but on preventing the specific type of interaction that could lead to a coordinated investment scheme involving the bidder and the Deemed Non-Investment. Second, asking Investors to certify that they never exercise control over a merchant banking investment is unreasonable. The Rule Proposal correctly notes that firms do not generally manage

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<sup>8</sup> See 69 Fed. Reg. 54253.

<sup>9</sup> See 69 Fed. Reg. 54252.

the day-to-day business of the entities in which they invest.<sup>10</sup> However, firms do reserve the right, and on rare occasions exercise their right, to influence or control certain material operations and investment decisions of their merchant banking and private equity-type investments. These include occasionally firing senior management of the company, approving the purchase of another company by the investment and making a decision to sell the company or partnership to another company. Indeed, the Federal Reserve Board in adopting regulations<sup>11</sup> circumscribing what constitutes a permissible merchant banking investment under the GLBA expressly permitted FHCs to restrict the ability of portfolio companies to engage in certain extraordinary activities and to require the affiliate to obtain approval of the FHC before taking actions outside the ordinary course of business. Clearly, the above activities involve “mak[ing] an operational or investment decision for the entity.”<sup>12</sup> Therefore, both adding the word “routine” to, and eliminating the word “control” from the proposed representation would allow Treasury to accomplish its auction-related objectives while being sensitive to the business realities of those investment relationships.

### 3. Conclusion

The Association appreciates this opportunity to comment on the Rule Proposal. If you have any questions about this letter, please do not hesitate to contact the undersigned at 646.637.9222 or via email at [efoster@bondmarkets.com](mailto:efoster@bondmarkets.com).

Sincerely,

Eric L. Foster  
Vice President and Associate General Counsel

cc: Mr. Timothy Bitsberger, *U.S. Department of the Treasury*  
Mr. Robert Elsasser, *Federal Reserve Bank of New York*  
Mr. Charles Andreatta, *Bureau of Public Debt*  
Legal Staff, *The Bond Market Association*

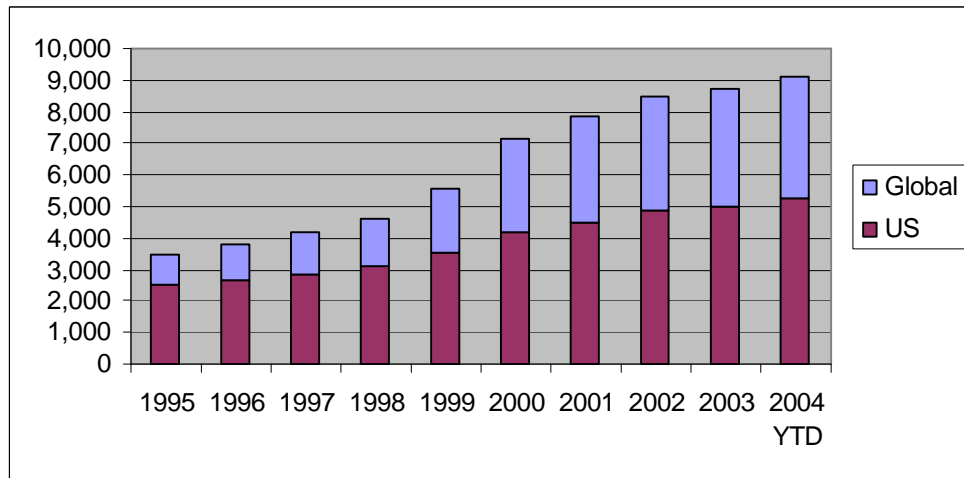
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<sup>10</sup> However, as explained *infra*, they do typically have the ability to restrict the ability of a portfolio company from engaging in certain extraordinary events. These actions typically include acquiring control of another company, the sale of the all of the assets of the company or significant changes in the business plan or accounting methods of policies of the company.

<sup>11</sup> See 66 Fed. Reg. 8484 (Jan. 31, 2001) codified at 12 C.F.R. Part 225, Subpart J (2004) (hereinafter “Regulation Y”).

<sup>12</sup> See 69 Fed. Reg. 54253.

*Appendix A*  
*Growth of Private Equity Funds-1995-2004*



Source: Thomson Financial.

Note: This chart includes venture capital funds, buyout funds, fund of funds, generalist private equity, mezzanine funds and other private equity and includes firms actively seeking new investments as well as entities that are inactive or making few (if any) investments.