May 27, 2022

Via Electronic Mail: rule-comments@sec.gov

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

Re: 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:

Managed Funds Association ("**MFA**")[1] appreciates the opportunity to provide comments to the Securities and Exchange Commission ("**SEC**" or "**Commission**") on the above-captioned notice of proposed rulemaking ("**Proposal**").[2] The Proposal would revise and expand the definitions of "dealer" and "government securities dealer" under Sections 3(a)(5) and 3(a)(44), respectively, of the Securities Exchange Act of 1934 ("**Exchange Act**").

MFA supports the goals of the Commission to protect investors and the markets. The Proposal, however, is unnecessary to achieve these objectives, and, in fact, will harm, rather than protect, investors and markets. If adopted, the Proposal would require a wide range and large number of private funds and their advisers, who are already subject to Commission registration, examination, and significant reporting requirements, to dually register as a dealer or government securities dealer. This would be an unjustified overreach and will have unintended consequences to investors and markets.

Alternative asset managers are important market participants. They serve investors such as pension plans, charitable foundations, and endowments, who require risk-adjusted returns to

[1] MFA represents the global alternative investment industry and its investors by advocating for regulatory, tax, and other public policies that foster efficient, transparent, and fair capital markets. MFA's more than 150 members collectively manage nearly $1.6 trillion across a diverse group of investment strategies. Member firms help pension plans, university endowments, charitable foundations, and other institutional investors to diversify their investments, manage risk, and generate attractive returns over time. MFA has a global presence and is active in Washington, D.C., London, Brussels, and Asia.

[2] SEC Release No. 34-94524 (Mar. 28, 2022), 87 Fed. Reg. 23,054 (Apr. 18, 2022) ("**Proposing Release**"), available at: https://www.govinfo.gov/content/pkg/FR-2022-04-18/pdf/2022-06960.pdf.

support their missions. Many private funds, as a result of this rule, will reduce trading or possibly leave the market entirely. This will lead to reduced investment opportunities for pensions, foundations, and endowments. Greater market concentration will increase systemic risk for the U.S. financial system. The rule will reduce liquidity, harm price discovery, and increase the cost of capital for companies and the U.S. government.

As we describe below, private funds and their advisers are already subject, directly or indirectly, to regulations that address the Proposal's main objectives. Treating private funds and their advisers as dealers would expose them and their investors—including pension plans, endowments, municipalities, and nonprofits—to unintended risks and increased costs. To address these issues and other serious flaws with the Proposal, any final rule should exclude private funds and their advisers.

Given the complexity of the Proposal and its broad scope, MFA has also requested an extension of the comment period.[3] We also plan to submit an economic impact analysis of the Proposal under separate cover to illustrate our concerns with the Proposal's effect on the vitality of financial markets. Due to the excessively short comment period, however, we will be submitting this analysis at a later date.

EXECUTIVE SUMMARY

The issues raised by the Proposal are of great concern to MFA and its members, and we appreciate the opportunity to share our views. The following is a summary of our positions, which we explain more fully below.

1. Advisers and the private funds they manage are already subject, directly or indirectly, to comprehensive regulation, which is sufficient to address the objectives of the Proposal without subjecting them to dealer registration.

2. Subjecting private funds and their advisers to dealer registration would expose funds and their investors to material costs and risks that the Proposal does not identify or address.

3. The Proposal's various tests are overbroad, vague, and would exceed the Commission's statutory authority. The Proposal also would violate the Administrative Procedure Act ("**APA**") due to its insufficient cost-benefit analysis, lack of fair notice, inadequate comment period, arbitrary and capricious categorization of market participants, and superficial or missing consideration of reasonable alternatives.

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[3] MFA along with other trade organizations submitted a request for an extension of time for the submission of comments on the Proposal. *See* Joint Letter Requesting Extension of Comment Period on File Nos. S7-12-22 (Mar. 28, 2022). We are disappointed that our extension was not granted, which would have provided us with time to respond to the Commission's many questions with quantitative feedback.

4. If the Commission believes, after due consideration of the issues laid out in this letter, that a rulemaking is still necessary and appropriate, then it should adopt an exception for private funds and their advisers, similar to the proposed exception for registered investment companies. It also should narrow its proposed tests and eliminate aggregation requirements, absent evasion.

OVERVIEW

The Proposal is motivated by advancements in electronic trading of securities, especially U.S. Treasuries, that have led certain unregulated trading firms to play a more significant role in the securities markets.[4] We do not take a view as to whether these firms, many of which are considered principal or proprietary trading firms ("**PTFs**"), should be subject to additional regulatory oversight. But the Proposal would go far beyond increasing oversight of PTFs. In particular, the Proposal would also subject many private funds and their advisers to duplicative and harmful regulation as dealers.

Over the years, the Commission has implemented a robust system of registration, compliance evaluation, custody requirements, recordkeeping, filings, regular exams, and enforcement oversight of investment advisers to private funds. These private funds also trade predominantly with or through registered broker-dealers, thus subjecting their trading activities to extensive margin, risk management, and reporting requirements.

Treating private funds and their advisers as dealers would in many instances result in unnecessary duplication of these requirements. But more problematically, such treatment would expose private funds and their investors to significant new risks and costs. The Proposal fails to identify, much less consider or justify, many of these risks and costs, including: registering as a dealer would cause a fund to lose its status as a "customer" when trading with broker-dealers, thus foregoing important sales practice and customer asset protections; funds and their investors would face treatment as "restricted persons" blocked from participation in the U.S. IPO market; and net capital requirements would impede investors' highly negotiated liquidity rights. We address these and other examples in greater detail below.

Rather than face these consequences, many private funds would curtail their trading or possibly exit the market. The Proposal would thus harm those funds, their investors, and, ultimately, the market as a whole, through reduced investment opportunities, reduced

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[4] *See, e.g.*, Chair Gary Gensler, *Prepared Remarks at U.S. Treasury Market Conference* (Nov. 17, 2021), available at: https://www.sec.gov/news/speech/gensler-us-treasury-market-conference-20211117 ("First, in the last couple of decades, electronification and the use of algorithmic trading have made transacting in this market faster than ever before. As a result, principal trading firms (PTFs), which some people call high-frequency trading firms, started participating significantly in this market. Today, these PTFs represent 50 to 60 percent of the volume on the interdealer broker (IDB) platforms."); James Collin Harkrader & Michael Puglia, Board of Governors of the Federal Reserve System, *Principal Trading Firm Activity in Treasury Cash Markets* (Aug. 4, 2020), available at: https://www.federalreserve.gov/econres/notes/feds-notes/principal-trading-firm-activity-in-treasury-cash-markets-20200804.htm.

competition, greater concentration and systemic risks, less efficient price discovery, and greater costs of capital-raising, for companies and the U.S. government.

The Proposal's failure to consider these consequences is the result of both conceptual errors and data analysis that, in the Commission's own words, is "highly uncertain"[5] and based on assumptions for which there is "considerable uncertainty."[6] As a result, the Proposal's economic analysis incorrectly assesses both the scope and number of affected firms and the direct and indirect costs of subjecting those firms to dealer registration, thus falling short of the Commission's obligations under the APA and Sections 3(f) and 23(a)(2) of the Exchange Act.

The Proposal also categorizes different market participants in ways that are arbitrary and capricious. Most egregiously, the Proposal would treat private funds and their advisers in the same manner as PTFs—even though there are manifest differences between how the two categories of entities are regulated (including Commission registration of private fund advisers), how they are funded (including the presence of outside investors in private funds), and how they operate (including the fiduciary duty owed by private fund advisers to their clients).

The Proposal would further provide a special exception to registered investment companies that it would not make available to private funds. However, the investment company regulatory requirements that the Proposal cites as the basis for this different treatment, namely leverage limitations and certain reporting requirements, do not justify this distinction in the context of a proposal to expand dealer registration because registered dealers are not subject to requirements equivalent to those for investment companies. Meanwhile, the issues that dealer registration would present for registered investment companies, *e.g.*, that it is "unclear how [they] would comply with net capital requirements, or how they would define net capital,"[7] would equally exist for private funds.

Moreover, the Proposal gives short shrift to reasonable alternatives. For example, it largely dismisses enhancing transaction reporting for private funds and their advisers instead of subjecting them to dealer regulation because this alternative would not subject these entities to broker-dealer net capital requirements or operational risk management provisions. But the Proposal does not consider how existing aspects of the broker-dealer rules, most notably margin requirements and risk management standards around market access, already address relevant leverage and risk management objectives when private funds trade with or through broker-dealers. The Proposal also fundamentally misunderstands the operation of broker-dealer net capital requirements, presuming them to act as a material leverage constraint when this is not necessarily the case (particularly when a dealer does not have a customer business).

Perhaps even more fundamentally, nowhere does the Proposal address why it must invent new tests for dealer registration in order to accomplish what appears to be the Commission's principal goal of requiring PTFs to register as dealers. In particular, it is notable that the multi-

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[5] Proposing Release at 23,085.

[6] *Id.* at 23,081.

[7] *Id.* at 23,094.

factor, facts-and-circumstances test for "dealer" and "government securities dealer" status that the Commission and courts have developed and applied, over the course of decades, takes into account whether a person acts as a market maker on an organized exchange or trading system or seeks to profit from providing liquidity as opposed to changes in market prices. These factors would appear to describe the trading activity that the Proposal ascribes to PTFs. We respectfully submit that appropriately applying and enforcing these existing factors should therefore be sufficient to achieve the Commission's goal, without resulting in the undesirable consequences identified above.

Instead, however, the Proposal devises multiple, brand-new, single-factor tests for when a person falls within the "dealer" or "government securities dealer" definition. The Commission's decision to proceed through a new definitional rulemaking, rather than enforcing its existing dealer registration requirements, suggests one of two things: either the existing "dealer" and "government securities dealer" definitions are not sufficiently broad to require firms to register when the Commission thinks such registration would be beneficial, or the existing definitions (and related guidance) do not embody a sufficiently clear test to put firms on notice that they must register as dealers. On the one hand, if the existing definitions are not sufficiently broad, then the problem lies with the scope of the Commission's statutory authority (as defined by existing court decisions), which the Commission cannot unilaterally enlarge through rulemaking. On the other hand, if the existing definitions (and related guidance) do not provide a sufficiently clear test, then adopting multiple brand-new tests, each presenting their own ambiguities as to who would need to register, would only compound the problem. In either case, the Proposal's approach presents serious procedural and other legal deficiencies.

In light of these issues, we recommend that the Commission refrain from adopting the Proposal until it has conducted a sufficient cost-benefit analysis and taken steps to clarify the Proposal's scope and fit it within the Commission's statutory authority. If the Commission instead proceeds with the Proposal in its current form, then we recommend it adopt certain exceptions, clarifications, and modifications necessary to avoid serious adverse and likely unintended consequences, including an exception for private funds and their advisers.

DISCUSSION

I. The Proposal's application to private funds and their advisers is not necessary to achieve its objectives and would lead to costs that outweigh the benefits.

Private funds and similar institutional investors play an important role with regard to price discovery, liquidity, competition, and capital formation in the securities markets. Indeed, the Commission itself has acknowledged the crucial role played by such firms in the proper functioning of the securities and government securities markets.[8] Thus it is highly concerning

[8] *See, e.g., Fact Sheet, Private Fund Proposed Reforms* (Feb. 9, 2022), available at: https://www.sec.gov/files/ia-5955-fact-sheet.pdf ("With more than $18 trillion in gross assets, private funds and their advisers play an important role in our financial markets and the lives of everyday Americans. Some of the largest private fund investors include state, municipal, and private pension plans that provide retirement and other benefits to the American public."); U.S. Securities and Exchange

that the Proposal would subject private funds and their advisers to unnecessary and unworkable regulation as dealers. If the Commission decides to adopt the Proposal, it should adopt an exception for private funds and their advisers, similar to the exception proposed for investment companies.

A. The Commission should not regulate private funds and their advisers as dealers because they are already comprehensively regulated.

As noted above, private funds and their advisers are already subject to extensive regulation by the Commission. In particular, registered investment advisers are subject to a comprehensive regulatory regime that covers, among other things, recordkeeping,[9] reporting,[10] compliance programs,[11] custody,[12] regulatory examinations and inspections, and antifraud rules.[13]

The Proposal superficially dismisses the extent to which this regime already achieves the benefits of dealer regulation. Instead, the Proposal focuses on three incremental benefits to regulating private funds and their advisers as dealers: transaction reporting, operational risk management, and net capital rules.[14] But the objectives of these requirements are already addressed when a private fund trades with or through a broker-dealer.

The transaction reporting requirements cited by the Proposal, such as TRACE reporting of fixed income securities trades, various trade-reporting facilities, and consolidated audit trail reporting requirements for equity securities trades, already apply to private funds when they trade with or through broker-dealers. To the extent that the data reported about the private fund

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Commission, *Annual Staff Report Relating to the Use of Form PF Data*, at 1 (Dec. 3, 2021) ("Private funds and their advisers play an important role in both private and public capital markets. These funds, including hedge funds, private equity funds and liquidity funds (which operate, in certain respects, similarly to money market funds), currently have approximately $11.7 trillion in net assets. Private funds invest in large and small businesses and use strategies that range from long-term investments in equity to rapid trading and investments in complex instruments. Their investors include individuals, institutions, governmental and private pension funds, and non-profit organizations. The economic activity of private funds is significant both to large portions of the capital markets and to many individual American investors."); Commissioner Luis A. Aguilar, *Institutional Investors: Power and Responsibility* (Apr. 19, 2013), available at: https://www.sec.gov/news/speech/2013-spch041913laahtm#P35_6851 ("Institutional investors are known to improve price discovery, increase allocative efficiency, and promote management accountability. They aggregate the capital that businesses need to grow, and provide trading markets with liquidity—the lifeblood of our capital markets.").

[9] 17 C.F.R. § 275.204-2.

[10] *Id.*

[11] 17 C.F.R. § 275.206(4)-7.

[12] 17 C.F.R. § 275.206(4)-2.

[13] *E.g.*, 17 C.F.R. § 275.206(4)-8.

[14] *See, e.g.*, Proposing Release at 23,095-96.

side of these trades does not adequately address relevant regulatory objectives, *e.g.*, because it does not report the fund's identity or parent/child order status to regulators, it would be far less costly and disruptive to address those issues directly through enhancements to the reporting rules.

The only operational risk management requirement cited by the Proposal is SEC Rule 15c3-5, which requires risk management controls for broker-dealers with market access. When a private fund or other customer trades through a broker-dealer to access a market, this rule already applies. In addition, broker-dealers subject their customers to a number of additional operational risk management requirements, including with respect to due diligence and other know-your-customer requirements and risk limits. Therefore, it is not necessary, and indeed would be duplicative, also to subject the fund or its adviser to dealer registration just to ensure application of these controls to the fund's or adviser's trading.

As regards net capital requirements, the Proposal repeatedly asserts that the broker-dealer net capital rule, Rule 15c3-1, constrains dealer leverage. This assertion is based on the erroneous assumption that a broker-dealer must maintain net capital above the greater of a percentage of its debt or a fixed minimum amount.[15] In reality, although paragraph (a)(1)(i) of Rule 15c3-1 sets forth a limit on a dealer's aggregate indebtedness, paragraph (a)(1)(ii) of the rule permits a dealer to elect not to be subject to this aggregate indebtedness standard; in lieu of that standard, the dealer is required to maintain net capital in excess of $250,000 or 2% of the aggregate debit items in the broker-dealer customer reserve formula, which generally correspond to margin loans and other instances in which a dealer has extended credit for or on behalf of customers. When the Commission adopted this alternative standard in 1975, it underscored the customer protection objective of the net capital rule[16]—an objective that is not relevant for firms who do not conduct a customer business.

For a broker-dealer not engaging in such a customer business, then, the minimum net capital requirement is, as a practical matter, only $250,000,[17] meaning that the broker-dealer

[15] *See id.* at 23,079 n. 205 ("Rule 15c3–1 requires dealers to maintain, at all times, net capital above the greater of: A percentage of debt (6.25 percent, or 11.1 percent for 12 months after commencing business as a broker or dealer), or a fixed minimum amount based on the types of business in which the dealer engages (the general amount for dealers without customers is $100,000)").

[16] *See* Adoption of Amendments To Rule 15c3-1 And Adoption of An Alternative Net Capital Requirement for Certain Brokers And Dealers, SEC Release No. 34-11497 (Jun. 26, 1975), 40 Fed. Reg. 29,795, 29,798 (July 16, 1975) ("The key factors which distinguish the securities industry from other industries are its custodial responsibility for customers' funds and securities and its role in facilitating capital raising for government and corporations. Accordingly, the scope and purpose of any rules and regulations concerning the fiscal responsibility of a broker or dealer should focus upon the construction of an environment in which financial miscalculations of a broker or dealer do not result in loss to its customers or the customers of another broker or dealer.").

[17] Paragraph (a)(1)(ii) of the net capital rule also requires a "dealer," including any broker-dealer that effects more than ten transactions for its own investment account in any one calendar year, to maintain net capital of not less than $100,000.

would only need to maintain $250,000 of liquid assets in excess of its unsubordinated liabilities to be in compliance with the net capital rule. In determining the amount of its liquid assets, the broker-dealer would, of course, need to take deductions ("haircuts") as set forth in the rule.[18] But for highly liquid securities, those deductions are relatively low, *e.g.*, in the range of 0 to 2% for Treasury securities with a maturity of less than 3 years. So, for example, a broker-dealer that had an inventory position of $25 billion of such short-term Treasuries could have a leverage ratio (*i.e.*, a ratio of unsubordinated liabilities to total assets) approaching 98% or even greater. On the other hand, the deductions would be much higher for certain other instruments (*e.g.*, derivatives and certain high-yield debt). As a result, the net capital rule functions more like a restriction on the types of investments and trading a firm can engage in than a restriction on leverage.

We also are surprised that the Commission would "estimate that qualifying hedge funds are more leveraged than registered dealers."[19] This assertion appears to be based solely on the Proposing Release's unconventional and self-serving definition of leverage as highly liquid assets minus secured debt.[20] The same report that the Proposing Release uses as the data source for this assertion defines leverage more conventionally as the ratio of hedge fund gross notional exposure to net asset value, and that report estimates an average hedge fund leverage ratio that, as of the second quarter of 2021, stood between 5 and 7.5 (if interest rate derivatives are included) or between 2.5 and 5 (if interest rate derivatives are excluded).[21] In comparison, the Federal Reserve Board estimates that, in the same period, broker-dealer leverage, measured as the ratio of assets to equity, stood between 15 and 20.[22] Although this comparison is not "apples-to-apples"—the fund leverage ratio more conservatively includes off-balance sheet notional amounts for derivatives, which tends to inflate the leverage ratio, whereas the broker-dealer leverage ratio only accounts for balance sheet assets—it illustrates that broker-dealers are at least between twice and eight times more leveraged than hedge funds.

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[18] In addition, by subjecting a broker-dealer to net capital deductions for its securities positions, the rule discourages broker-dealers from maintaining open positions because the larger the broker-dealer's position, the more capital (equity and subordinated debt) it must raise. This incentive would actually run counter to the Proposal's market stability objectives by making it more costly for the firms that would be required to register by the Proposal to take net directional positions countercyclical to the market. For example, without being able to hold positions in inventory without incurring a net capital charge, a firm may not have the ability to quickly (if at all) buy securities when most of the market is selling, which could dry up liquidity and increase volatility.

[19] Proposing Release at 23,085.

[20] *Id.* We consider this definition self-serving because, instead of the conventional comparison of a person's assets to equity, it compares the same characteristics (liquid assets vs. debt) addressed by the net capital rule, which of course helps justify application of the net capital rule.

[21] *See* Division of Investment Management Analytics Office, SEC, Private Fund Statistics: Second Calendar Quarter 2021 (Jan. 14, 2022), Figure 10, available at: https://www.sec.gov/divisions/investment/private-funds-statistics/private-funds-statistics-2021-q2.pdf.

[22] *See* Board of Governors of the Federal Reserve System, Financial Stability Report (May 2022) ("**Financial Stability Report**"), Figure 3.5, available at: https://www.federalreserve.gov/publications/files/financial-stability-report-20220509.pdf.

We also note that margin requirements have traditionally acted to limit leverage in the securities markets. Federal Reserve Regulations T, U, and X impose extensive limits on the amounts that a fund or other investor can borrow against its equity securities positions. Financial Industry Regulatory Authority ("**FINRA**") Rule 4210 imposes additional margin requirements on a fund borrowing from a broker-dealer, including with respect to fixed income securities. Ironically, were a fund to register as a dealer, however, it may become eligible for exemptions and exceptions from many of these margin requirements.[23] But the Proposal fails to consider this dynamic.

B. Regulating private funds and their advisers as dealers would harm investors.

Regulating private funds and their advisers as dealers would expose private funds and their investors to extensive additional risks and costs. Below are some key examples:

1. <u>Loss of Customer Asset Protection</u>

A broker-dealer that handles customer funds and securities is subject to SEC Rule 15c3-3, which requires the broker-dealer to make deposits in a customer reserve account to cover the funds it owes its customers and to maintain possession or control of customer fully paid or excess margin securities. If a private fund registered as a dealer, however, it would lose its "customer" status under Rule 15c3-3 and instead subject its assets to the less protective rules for proprietary accounts of a broker-dealer, including less demanding possession or control requirements and commingling of its assets with those of other broker-dealers instead of customers. In addition, the fund would lose the right to advances from the Securities Investor Protection Fund in the event its carrying broker-dealer suffers a shortfall in customer assets in an insolvency.

2. <u>Loss of SEC and FINRA Sales Practice Protections</u>

SEC and FINRA rules subject a broker-dealer to various sales practice protections in its dealings with customers, including suitability requirements for recommendations (FINRA Rule 2111), restrictions on markups and obligations to provide fair prices (FINRA Rule 2121), requirements to achieve best execution of customer orders (FINRA Rule 5310), prohibitions on trading ahead of customer orders (FINRA Rule 5320), requirements to provide extensive disclosures regarding conflicts of interest and other matters in transaction confirmations (SEC Rule 10b-10 and FINRA Rule 2232), and requirements to provide periodic account statements (FINRA Rule 2231), among other protections. However, these requirements all turn on a person qualifying as a "customer," and broker-dealers do not qualify. As a result, subjecting a private fund to registration as a dealer would deprive it of these protections.

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[23] *See, e.g.*, 12 C.F.R. § 220.7 (provisions of Regulation T permitting lesser margin requirements for a broker-dealer credit account than a margin account), 12 C.F.R. § 221.5 (provisions of Regulation U permitting special-purpose loans to brokers and dealers), and FINRA Rule 4210(e)(6) (provision of Rule 4210 permitting lesser margin requirements for broker-dealer accounts than customer accounts).

In addition, in the context of cross-border trading, the Exchange Act's broker-dealer registration requirement, and the conditions to the registration exemption in SEC Rule 15a-6, protect U.S.-based funds and advisers by requiring the foreign broker-dealers with whom they trade either to register with the Commission or to transact through a registered broker-dealer that applies various customer protections to the transaction.[24] By contrast, were a private fund to register as a dealer, foreign broker-dealers could transact with it directly, without applying these protections.[25]

3. Loss of Liquidity Rights

Private fund investors typically have heavily negotiated liquidity rights permitting them to redeem their investments upon satisfaction of certain conditions. If a private fund registered as a dealer, however, these liquidity rights could raise questions under the broker-dealer net capital rule, such as whether investors' interest in funds could qualify as equity capital.[26] If liquidity rights disqualified investors' fund interests, investors likely either would need to forego their liquidity rights or see their fund interests diluted or otherwise impaired as a result of the fund needing to raise qualifying equity or subordinated debt in order to satisfy its net capital requirements.

4. Lost Access to the U.S. IPO Market

FINRA Rule 5130 generally prohibits a broker-dealer and its associated persons from selling "new issues" (generally speaking, U.S. initial public offerings) to any account in which a "restricted person" has a beneficial interest. FINRA members and other broker-dealers are restricted persons under this rule, meaning that a private fund that registered as a dealer would become subject to these restrictions. Even worse, the rule also defines certain owners of a broker-dealer as restricted persons, meaning that some investors in a private fund that registered as a dealer would also lose access to the U.S. IPO market, even in connection with their investment activity away from the private fund. In order to preserve access to the U.S. IPO market, it also is commonplace for other collective investment vehicles to deny investments by restricted persons, so an investor in a private fund that registered as a dealer might also lose access to these other investment opportunities, too. These restrictions also would have correlative negative effects on issuers seeking to access the IPO market in the U.S.[27]

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[24] *See* 17 C.F.R. § 240.15a-6(a)(3).

[25] *See* 17 C.F.R. § 240.15a-6(a)(4).

[26] For example, issues relating to the accounting treatment of mandatorily redeemable financial instruments (including certain partnership and LLC interests) as non-equity liabilities led the SEC staff in 2004 to grant temporary no-action relief to certain broker-dealers permitting them to add the carrying value of those instruments to their regulatory net worth. *See* Letter to Marshal J. Levinson, Chair, Capital Committee, Securities Industry Association, from Michael A. Macchiaroli, Associate Director, Division of Market Regulation, SEC, dated Feb. 19, 2004. But this relief is no longer in effect.

[27] For a discussion of the negative effects of the Proposed Rules on issuers, see Section III.A, *infra*.

5. Lost Access to Certain Investment Strategies

The "haircut" provisions of the broker-dealer net capital rule generally make it difficult for a registered dealer to engage in making certain less liquid investments due to the size of the haircuts that apply to those investments, which can be 100%, even though the investments can be entirely appropriate for private funds depending on investors' liquidity rights and the fund's overall portfolio mix. Also, the net capital rule only recognizes very limited offsets among related positions, which makes it exceedingly difficult for a registered dealer to engage in derivatives trading. Compounding this difficulty is the fact that initial margin posted by a registered dealer for non-cleared derivatives is subject to a 100% capital deduction under many circumstances. These aspects of the net capital rule would prevent a private fund registered as a dealer, and, indirectly, the fund's investors, from engaging in investment strategies involving these sorts of instruments, which would limit the returns those investors can make.[28]

6. Increased Personnel and Infrastructure Costs

A broker-dealer must have at least two FINRA-registered principals (including a financial and operational principal), have a FINRA-registered chief compliance officer, and, in many instances, its traders and other personnel must register with FINRA. A broker-dealer also needs specialized infrastructure to comply with applicable financial and operational requirements, such as the net capital rule, and infrastructure enabling inter-day computation, monitoring, and reporting of capital, likely with allocation of capital charges by portfolio or trading desk. By contrast, most funds lack such personnel and infrastructure to meet these requirements. Indeed, it is typical for certain funds not to have *any* personnel, meaning that the fund may need to rely mostly or exclusively on dual-hatted advisory personnel that also act for affiliated funds—but the Proposal does not consider the implications of that structure under Commission or FINRA rules. Because the Proposal would, in many cases, subject the fund itself to dealer registration and regulation, the fund (and thus its investors) would need to bear these increased personnel and infrastructure costs.

C. Regulating private funds and their advisers as dealers would harm the markets and broader economy.

As a fiduciary to the funds it manages, a private fund adviser could not weigh the risks and costs summarized above lightly. Instead, it seems likely, in at least some number of circumstances, that an adviser would cease (or be compelled by its investors to cease) engaging

[28] To the extent that the fund restructured its securities-trading activity triggering dealer registration to take place through a separate entity from the entity engaged in these other strategies, then that more complex structure could present questions and issues relating to a broker-dealer and affiliated investment adviser sharing personnel and information with each other or engaging in trading with each other. Certain new dealers may need to rely mostly or exclusively on such dual-hatted advisory personnel that also act for affiliated funds, but it does not appear that the Commission has considered the implications of such arrangements under SEC or FINRA rules.

in activities that would cause the funds it manages to trigger dealer registration under the Proposal.

The ultimate impact of private funds and their advisers modifying or curtailing their trading activity due to the Proposal would be significant because of the extreme breadth of the Proposal. As described in Section III below, we have serious doubts regarding the accuracy of the Commission's economic analysis, which is based on limited data and seems not to account for the Proposal's requirements to aggregate trading activity based on common control.[29] Based on our members' anecdotal analysis, which we intend to supplement through a subsequent economic impact analysis submission, we think that the likely number of affected funds is far larger than the Commission estimates.

If these funds curtailed their trading or exited the market, then companies and the U.S. government would lose a significant portion (in some cases a majority) of their primary market investors, thus materially raising the cost of capital—a daunting prospect in the present environment of rising interest rates.[30] We also note that, even if certain funds did not modify their trading activity, and instead registered as dealers, then by operation of the new issue restrictions in FINRA Rule 5130 summarized above, the Proposal would cause the U.S. IPO market to shrink. Within the secondary markets, the reduction in arbitrage and similar investing strategies that contribute to price discovery and liquidity would also increase volatility and decrease market stability.

D. The proposal to exclude registered investment companies but not private funds or other regulated investors is arbitrary and capricious.

Notably, the Proposal would exclude registered investment companies from dealer and government securities dealer status. The Commission's rationale for this exclusion is that investment company regulation addresses many of the same objectives as dealer regulation while investment companies would face unique issues if required to register as dealers. We fail to see why that is the case. Registered investment companies are no more subject to transaction reporting, operational risk management, or net capital requirements than private funds.[31] Although registered investment companies would face issues with satisfying broker-dealer net capital requirements,[32] so would private funds. Indeed, like private funds, other regulated investors, such as pension plans and insurance companies, also would face these issues.

It seems that the main regulations that perhaps set registered investment companies apart from private funds and these other regulated investors are statutory limits on indebtedness, rules

[29] As discussed below, such aggregation not only would expand the range of persons captured by the proposed quantitative test for government securities dealer status but would also lead, perhaps inadvertently, to expanding those captured by qualitative tests that instead seem designed to apply to particular trading strategies, not coincidental trading across independent trading units.

[30] *See* Section I.B.4, *supra*.

[31] Also, like private funds, they are not required to join FINRA or any other self-regulatory organization.

[32] *See* note 6, *supra*.

that limit leverage risk, and portfolio- and position-reporting rules. No aspects of the broker-dealer regime are analogous to these regulations, and so we fail to see why they should justify better treatment for registered investment companies. In particular, as discussed above, the broker-dealer net capital rule does not limit leverage in the same manner as investment company regulation; we further note that investment company limits on indebtedness and leverage are less relevant to private funds given the latter category tends to have more limited redemption rights and thus a more stable investor base and liquidity profile. Nor are broker-dealers subject to portfolio- or position-reporting rules akin to investment companies, whereas private fund advisers already provide extensive reporting on Form PF. If the Commission's goal is to limit leverage or increase portfolio-wide or position-level regulatory transparency, then it could address those goals directly through changes to margin and reporting requirements for private funds and other investors. Expanding dealer regulation is completely opposed to those goals, and so those goals cannot justify the Proposal.

E. The Commission can achieve its objectives without subjecting private funds or their advisers to dealer regulation.

For the reasons set forth above, the Commission should, if it proceeds to finalize the Proposal, expand the registered investment company exception to cover any person registered as an investment adviser (or exempt or excluded from such registration other than as a family office), as well as any private fund client of such adviser (and any affiliated general partner, managing member, or similar control person of the private fund client), with respect to trading done by the person with or through a registered broker-dealer, a bank acting pursuant to an exception from the "broker" or "dealer" definition, a foreign broker-dealer acting pursuant to Rule 15a-6 or related no-action relief, or a registered or exempt government securities broker or dealer.[33] The parameters of this exception would be designed to ensure that the regulatory protections of Section I.A above apply, while also avoiding the investor and market harms described in Sections I.B and I.C above.

We recognize that one concern the Commission might have with adopting an exception for private funds and their advisers is the possibility that PTFs and similar firms might, to avoid dealer registration, restructure as private funds or similar entities. This scenario seems unlikely to us, as any such restructuring would give rise to various undesirable corporate, employment, and tax consequences. Moreover, because our proposed exception would not apply to family offices, such a restructuring would likely entail the firm subjecting itself to investment adviser regulation, with all of the attendant obligations summarized above, as well as an opportunity for the Commission to identify and take action against this evasive conduct. In this regard, it would

[33] If the Commission adopts the proposed aggregation rule described in Section VII, *infra*, then it should adopt a parallel investment adviser exception from the second prong of the proposed "own account" definition. Moreover, even if the Commission does not adopt this broader investment adviser exception, it should expand the "own account" exception for clients of registered investment advisers also to cover clients of persons exempt or excluded from investment adviser registration (other than clients of family offices).

be far simpler for the Commission to prohibit a firm from willfully evading the rule by engaging in such a restructuring.

II. The Proposal would upend decades of precedent and exceed the Commission's statutory authority.

A. The Proposal's shift to an effect-based approach to determining dealer status would inappropriately depart from long-standing precedent and chill liquidity-providing activity by requiring market participants to constantly second-guess legitimate trading strategies.

The Proposal would upend decades of Commission and court precedent by focusing on whether a firm's trading had the *ex post* effect of providing liquidity rather than the firm's reasoning for its trading. Specifically, the Proposal would provide that a market participant that "engages in a routine pattern of buying and selling securities (or government securities) that *has the effect of providing liquidity* to other market participants" would—regardless of any other attributes of its trading activity—be deemed to trade securities or government securities "as a part of a regular business" and be considered a dealer under Section 3(a)(5) of the Exchange Act or a government securities dealer under Section 3(a)(44) of the Exchange Act.[34] The Commission specifically notes that a person's intent is irrelevant to this analysis.[35]

This approach would subject a firm to constant second-guessing with respect to its dealer status based on whether its execution of a given investment or trading strategy had the incidental effect of providing liquidity, regardless of intent. As a result, the Proposal would be counterproductive, encouraging firms to affirmatively structure their activity to avoid any appearance of providing liquidity, even as a byproduct of their market activities, to avoid unintended dealer registration. This would, in turn, reduce market liquidity, increase volatility, and impair the Commission's goal of facilitating efficient markets. This impact will be particularly felt by MFA members as private fund advisers are investors not dealers, and this uncertainty will force them to change their approach to investing, as dealer status is untenable for these firms.

The Proposal's approach stands in stark contrast to the Commission's long-standing approach to dealer determinations, which has been a foundational element to the growth and success of the institutional investor community.[36] For decades, the Commission and courts have refined and applied the so-called "dealer-trader" distinction, with the aim of subjecting to dealer registration only those market participants "engaged in the business of buying and selling securities … for such person's own account … as a part of a regular business."[37] Beginning at

[34] Proposing Release at 23,064-65 (emphasis added).

[35] *Id.* at 23,066 n.131.

[36] *See, e.g.*, Paul A. Gompers & Andrew Metrick, *Institutional Investors and Equity Prices*, 116 Q.J. Econ. 229 (2001).

[37] 15 U.S.C. § 78c(a)(5)(A) (dealer); *see also* 15 U.S.C. § 78c(a)(44)(A) (government securities dealer).

least as early as 1951 with the publication of Professor Loss's seminal treatise,[38] Commission staff have consistently interpreted this distinction not to require hedge funds and other active investors to register as dealers or government securities dealers.[39] Importantly, this staff guidance has consistently emphasized a multi-variable, facts-and-circumstances test for identifying dealers, which has significant emphasis on customer interactions.[40]

Over the subsequent years, the Commission itself has consistently embraced this same approach. For example, in 1998, it used this approach to distinguish a limited-purpose OTC derivatives dealer from a full-purpose broker-dealer.[41] Then again, in 2002, when addressing the permissible securities activities of banks, the Commission similarly explained:

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[38] Louis Loss, Securities Regulation 722 (1st ed. 1951) (discussing the dealer-trader distinction).

[39] *See, e.g.*, *Public Securities Locating Services*, SEC Staff No-Action Letter (Sept. 8, 1973); *Burton Securities*, SEC Staff No-Action Letter (Dec. 5, 1977); *United Trust Company*, SEC Staff No-Action Letter (Sept. 6, 1978); *Stephen V. Hart*, SEC Staff No-Action Letter (Mar. 6, 1980); *United States Savings Association of Texas*, SEC Staff No-Action Letter (Apr. 12, 1987); *Louis Dreyfus Corp*., SEC Staff No-Action Letter (July 23, 1987); *Continental Grain Company*, SEC Staff No-Action Letter (Nov. 6, 1987); *Fairfield Trading Corp*., SEC Staff No-Action Letter (Jan. 10, 1988).

[40] *See, e.g., United Savings Ass'n of Texas*, SEC No-Action Letter (Apr. 2, 1987) (noting that a firm that engaged in government securities transactions would not be required to register as a government securities dealer as long as it traded solely for its own investment account and did not engage in the following: (1) issue or originate securities that would qualify as government securities under the Act as amended; (2) participate in a selling group or underwrite government securities; (3) purchase or sell government securities as principal from or to customers; (4) carry a dealer's inventory; (5) quote a market in government securities; (6) advertise or otherwise hold itself out as a government securities dealer, such as holding itself out as being willing to buy and sell particular government securities on a continuous basis; (7) render any incidental investment advice; (8) extend or arrange for the extension of credit in connection with government securities; (9) run a book of repurchase and reverse repurchase agreements on government securities; and (10) use an interdealer broker to effect any government securities transactions).

[41] OTC Derivatives Dealers, SEC Release No. 34-40594 (Oct. 23, 1998), 63 Fed. Reg. 59,362, 59,370 n.61 (Nov. 3, 1998) ("[A]n OTC derivatives dealer may not engage directly or indirectly in any activity that may otherwise cause it to be a 'dealer' as defined in Section 3(a)(5) of the Exchange Act (15 U.S.C. § 78c(a)(5)). This includes, but is not limited to, without regard to the security, (1) purchasing or selling securities as principal from or to customers; (2) carrying a dealer inventory in securities (or any portion of an affiliated broker-dealer's inventory); (3) quoting a market in or publishing quotes for securities (other than quotes on one side of the market on a quotations system generally available to non-broker-dealers, such as a retail screen broker for government securities) in connection with the purchase or sale of securities permitted under Rule 15a-1; (4) holding itself out as a dealer or market-maker or as being otherwise willing to buy or sell one or more securities on a continuous basis; (5) engaging in trading in securities for the benefit of others (including any affiliate), rather than solely for the purpose of the OTC derivatives dealer's investment, liquidity, or other permissible trading objective; (6) providing incidental investment advice with respect to securities; (7) participating in a selling group or underwriting with respect to securities; or (8) engaging in purchases or sales of securities from or to an affiliated broker-dealer except at prevailing market prices.").

> A person generally may satisfy the definition, and therefore, be acting as a dealer in the securities markets by conducting various activities: (1) underwriting; (2) acting as a market maker or specialist on an organized exchange or trading system; (3) acting as a de facto market maker whereby market professionals or the public look to the firm for liquidity; or (4) buying and selling directly to securities customers together with conducting any of an assortment of professional market activities such as providing investment advice, extending credit and lending securities in connection with transactions in securities, and carrying a securities account. These principles demonstrate that the analysis of whether a person meets the definition of a dealer depends upon all of the relevant facts and circumstances.[42]

The Commission subsequently returned to this distinction when it came time in 2012 to implement the Dodd-Frank Act's security-based swap dealer rules, applying similar factors to distinguish dealers from traders in that context.[43]

Broadly speaking, this long-standing guidance has turned on objective facts related to *how* and *why* an entity interacts with financial markets (*e.g.*, customer interactions, functioning as a market maker, or holding oneself out to other market participants as an entity willing to buy and sell securities as a part of a regular business) rather than merely looking to the *effect* of such interactions. While we acknowledge that this traditional dealer-trader analysis is not a *per se* intent-based test, the multi-factor analysis that focused on why and how a firm engaged with securities markets has allowed market participants to determine, *ex ante*, whether any particular proposed activity would likely subject them to regulation as a dealer.

We respectfully submit that this existing legal framework for determining dealer status and distinguishing between dealers and traders is fit for purpose and, if properly applied and enforced, sufficient to subject persons acting as dealers to dealer registration without the need for a new rulemaking.

B. The Proposal exceeds the Commission's statutory authority to define who constitutes a "dealer" or "government securities dealer."

As noted above, the Commission and the courts have consistently interpreted the "dealer" and "government securities dealer" definitions to require analysis of all of the relevant facts and circumstances and evaluation of multiple factors. In no instance has a court or the Commission

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[42] Definition of Terms in and Specific Exemption for Banks, Savings Associations, and Savings Banks Under Sections 3(a)(4) and 3(a)(5) of the Securities Exchange Act of 1934, SEC Release No. 34-46745 (Oct. 30, 2002), 67 Fed. Reg. 67,496, 67,498–500 (Nov. 5, 2002).

[43] *See* Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant," and "Eligible Contract Participant," Final Rules, SEC Release No. 34–66868 (Apr. 27, 2012), 77 Fed. Reg. 30,596, 30,599 (May 23, 2012).

indicated that any single factor is necessarily determinative. Nor has there ever been a purely quantitative test for dealer or government securities dealer status.

Notwithstanding this, the Proposal, for the first time, would deem a person to qualify as a dealer or government securities dealer merely because of a single characteristic of its trading activity. In so proposing, the Commission seems to be elevating an individual factor identified in merely one of its releases—"acting as a de facto market maker or liquidity provider"—expanding on it in novel and frequently ambiguous respects that ignore the rest of the text of that very same factor (". . . whereby market professionals or the public look to the firm for liquidity"), and making it the sole determinant of dealer status.[44] In this regard, the quantitative test is particularly troubling, as it replaces an analysis of a firm's trading with a blunt, bright-line threshold where an arbitrary level of trading *volume* alone is determinative—even if a firm is solely purchasing *or* selling, not purchasing *and* selling as the statute requires. But the Commission never addresses why a simple buy-and-hold investor qualifies as a dealer solely because of the volume of its purchases.

The Proposal also fails to address cases that emphasize the need for a customer-facing business in order for a person to qualify as a dealer[45]—a factor starkly missing from the Proposal's various tests. The statute, as it has often been interpreted by the courts and the Commission in the past, simply does not support the Proposal.

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[44] *See* Proposing Release at 23,059. Although this section of the Proposing Release also references two other factors—acting as a market maker or specialist on an organized exchange or trading system and holding oneself out as buying or selling securities at a regular place of business—none of the Proposal's new tests for dealer status in fact address either of these factors in any meaningful respect given that they are not limited to trading on an organized exchange or trading system or address when a person is "holding itself out" as buying or selling.

[45] *See, e.g.*, *Chapel Investments, Inc.* v. *Cherubim Interests, Inc.*, 177 F. Supp. 3d 981, 990 (N.D. Tex. 2016) ("To be considered a dealer, a person must be engaged in the securities business, such as soliciting investor clients, handling investor clients' money and securities, rending investment advice to investors, and sending investors subscription agreements for their review and execution. These factors, which are equally indicative of broker activities, distinguish the activities of a dealer from those of a private investor or trader" (internal citations and quotations omitted)); *In re ScripsAmerica, Inc.* 634 B.R. 863, 872 (Bankr. D. Del. 2021) ("Dealers are distinguished from investors and traders because they have customers and derive their income from marketing securities for sale to customers or from being compensated for services provided as an intermediary or market-maker. Dealers effect securities transactions for customers, for which they typically charge a commission or other transaction-based fee. Whereas an investor or trader may buy securities from issuers at substantial discounts and resell them into the public market for immediate profit, a dealer buys and sells securities from its customer and to its customer" (internal citations and quotations omitted)).

III. The Proposal fails to satisfy the Administrative Procedure Act and the Exchange Act's cost-benefit requirements.

The Proposal fails to satisfy the Commission's obligations under the APA[46] and Sections 3(f) and 23(a)(2) of the Exchange Act because it includes insufficient and flawed cost-benefit analysis, does not provide fair notice to affected market participants, and does not provide a sufficiently lengthy comment period. In addition, certain of the issues noted above, such as arbitrary and capricious categorization of different market participants and failures adequately to consider reasonable alternatives, also constitute APA violations.

A. The Proposal's cost-benefit analysis is insufficient and flawed.

The Commission has not adequately considered the significant costs to market participants, securities markets, and the broader economy that will almost certainly result from the Proposal, as it is required to do under the APA and the Exchange Act. The APA stipulates that a regulatory action is unlawful if it is "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law"[47] and courts have held that proposed regulations are arbitrary and capricious where the regulator has failed to adequately assess the economic impact of a proposed rule.[48]

Here, we respectfully note that the Commission has made a number of significant errors or omissions in its economic analysis. In many instances, the Commission relies upon incorrect or uncertain data to support the Proposal. For example, in estimating how many PTFs would become subject to the dealer registration requirement under the Quantitative Test (defined below), the Commission relies upon a subset of TRACE data where the identity of trading counterparties is known, which represents just 42% of that dataset,[49] is limited to dealer-to-dealer trading, and does not consider the dealer-to-customer market actually implicated by the Proposal.

The Commission similarly acknowledges that "[t]he extent to which hedge funds may satisfy the standards is uncertain," and that it lacks "[s]tructured data" to determine the number

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[46] 5 U.S.C. § 551 *et seq*. The Commission is subject to a number of additional procedural requirements related to its rulemaking authority, including with respect to cost-benefit analyses, under other statutes and case law. *See, e.g.*, 15 U.S.C. § 77b (noting that the Commission is required to consider efficiency, competition, and capital formation whenever it is "engaged in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest"); *Business Roundtable* v. *SEC*, 647 F.3d 1144, 1150 (D.C. Cir. 2011); *Chamber of Commerce* v. *SEC*, 412 F.3d 133, 144-5 (D.C. Cir. 2005).

[47] 5 U.S.C. § 706(2)(A).

[48] *See Business Roundtable* v. *S.E.C.,* 647 F.3d 1144, 1148 (D.C. Cir. 2011).

[49] Proposing Release at 23,080 n.217. The Commission discards the rest of the data from its analysis but assumes "all non-FINRA member market participants are equally represented in both the anonymous and identified subsets of TRACE." *Id.* at 23,081.

of hedge funds that would satisfy the qualitative standards.[50] But the Proposal's economic analysis of hedge funds potentially captured by the proposed quantitative standard is equally flawed. For example, the Proposal contends that that standard would capture 96% of the U.S. Treasury transactions by non-FINRA members reported under TRACE, while at the same time claiming that Treasury basis trading would not be captured[51]—yet the Proposing Release does not reconcile these two statements, which seem incongruous given the prevalence of basis trading. We also note that the Commission only looked at data from July 2021, when volumes were relatively low, which is inappropriate and not representative of volume in the Treasury markets, generally. Finally, we note that these examples represent just some of the substantial data limitations in the Proposal.[52]

Such a limited dataset can hardly be considered representative or reliable, and the Commission concedes as much in acknowledging the "considerable uncertainty" underlying its assumptions and analysis.[53] With respect to all potentially affected market participants, the Commission concedes that "the precise number of affected parties is uncertain, since existing data does not provide a clear picture of all market participants' activities."[54] The Commission again concedes that it has relied upon incomplete and, ultimately, inadequate data in connection with this rulemaking. The Commission's analysis, therefore, is too uncertain to present a reliable picture of the costs of the Proposal. In order to comply with its APA obligations, we believe that the Commission should gather sufficient data and conduct an appropriate cost-benefit analysis before promulgating any final rules.

As another example, the Commission estimates a mere $600,000 in costs to a firm to initially register as a dealer with the Commission and $265,000 in annual costs thereafter.[55]

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[50] *Id.* at 23,082.

[51] We agree with the Commission that Treasury basis trading should not be captured by a government securities dealer registration test, and believe that excluding repurchase, reverse repurchase, and futures transactions from relevant tests would help exclude such trading, but we note that the Proposal does not address, as it should, the exclusion of ancillary activities, such as rolling a basis trade position or managing the Treasury leg of the position based on changes in the cheapest-to-deliver security.

[52] *See, e.g.,* Proposing Release at 23,083-85 ("The precise number of affected parties is uncertain, since existing data does not provide a clear picture of all market participants' activities. For instance, we do not know how many PTFs routinely express trading interests that are at or near the best available prices on both sides of the market. Nevertheless, the discussion in this section seeks to provide some idea, based on available data, of the Proposed Rules' scope . . . . The precise number of affected parties is highly uncertain, due to several shortcomings. The U.S. Treasury market analysis has the following caveats. . . . There are also caveats to the equity market analysis.").

[53] *Id.* at 23,081.

[54] *Id.* at 23,083.

[55] *Id.* at 23,089. The Commission notes that these costs "include personnel hours, outside legal services, building and maintaining books and records systems, obtaining or maintaining employee licensure, and direct costs associated with calculating net capital to comply with the Net Capital Rule." *Id.* We believe

Remarkably, the Proposal acknowledges that compliance with a single dealer requirement (consolidated audit trail reporting) may exceed $8 million,[56] but if this is the case, then simple arithmetic dictates that the aggregate costs of implementing the dealer regime as a whole will be multiples of the Commission's $600,000 estimate. As another example, it seems that the Commission has not sufficiently considered the costs of complying with the net capital rule, which could include (i) raising additional capital on less attractive terms in order to maintain the same investment strategies after taking into account the rule's haircuts and (ii) building and maintaining the infrastructure and hiring personnel necessary to stay in compliance with the net capital rule. We also note that it is not clear how certain aspects of the net capital rule will apply in the context of private funds (*e.g.*, how will the Commission treat investor interests in private funds for net capital purposes?), which adds an additional layer of cost and complexity. Our members have therefore informed us that the cost estimates in the Proposing Release are extremely low and that, conservatively, given the complex nature of their businesses, they would have to expend far more than what the Commission estimates in order to register and remain in compliance with the Commission's extensive dealer regulations on an ongoing basis.

Furthermore, the Commission's analysis does not consider the broader market context and consequences of the Proposal, including the costs associated with reduced liquidity, increased volatility and less capital formation that will likely result from firms leaving, or limiting their participation in, certain markets to avoid dealer registration. It is illogical to think that a rule that substantially increases the fixed costs of entering the market will promote competition; more likely, the Proposal would result in a barrier to entry that increases market concentration and decreases competition.

The Commission's analysis likewise fails to consider the cumulative impact of the Proposal in conjunction with the Commission's numerous other recent proposals, including some that directly and substantially impact the markets and market participants that are subject to this Proposal, such as the proposed rules for private fund advisers.[57] We are concerned that the cumulative burdens associated with these proposed rules will prove so onerous for private funds that many will choose to significantly curtail their market activity. Had the Commission considered all of these costs, we respectfully submit that it would have concluded that the costs of the Proposal, as drafted, significantly outweigh any purported benefits.

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that hiring a qualified CCO for a complex organization alone could very well exceed the Commission's total estimated annual cost.

[56] *Id.* at 23,090.

[57] *See* SEC Release No. IA-5955, Proposed Rule on Private Fund Advisers & Documentation of Registered Investment Adviser Compliance Reviews (Feb. 9, 2022), available at: https://www.sec.gov/rules/proposed/2022/ia-5955.pdf; *see also* SEC Release No. 34-94062, Proposed Rule on Amendments Regarding the Definition of "Exchange" and Alternative Trading Systems (ATSs) That Trade U.S. Treasury and Agency Securities, National Market System (NMS) Stocks, and Other Securities (Jan. 26, 2022), available at: https://www.sec.gov/rules/proposed/2022/34-94062.pdf.

B. The Proposal does not provide fair notice to affected parties.

The APA requires federal agencies to provide notice and an opportunity to comment on regulatory proposals.[58] To satisfy the rulemaking requirements of Section 553 of the APA, an agency "must provide sufficient factual detail and rationale for the rule to permit interested parties to comment meaningfully." An agency must give "interested persons an opportunity to participate in the rule making" and the "affected party should have anticipated the agency's final course in light of the initial notice."[59] Integral to an agency's notice requirement under the APA "is its duty to identify and make available technical studies and data that it has employed in reaching the decisions to propose particular rules."[60]

The Proposal fails to provide sufficient notice of the proposed scope of the rule and fails to give notice of who would be affected by the Proposal. As described in detail below, many of the fundamental aspects of the Proposal as proposed are too ambiguous for the Commission to have provided affected firms with fair notice of the rules and their potential impacts. In addition, because the Proposal's cost-benefit analysis is insufficient under the Exchange Act, the Proposal does not provide affected parties with the necessary information to formulate their views. We acknowledge that such an analysis may be difficult, but, in order to comply with its APA obligations, we believe that if the Commission desires to proceed with the Proposal, it must first gather sufficient accurate data and conduct an appropriate cost-benefit analysis.

C. The Proposal does not provide an adequate comment period.

The APA also requires that agencies provide affected parties with "enough time with enough information to comment and for the agency to consider and respond to the comments."[61] The courts and Congress agree that public comment periods must be commensurate with the length, complexity, and significance of rulemakings.

Here, the approximately two-month comment period is simply too short to address 84 separate requests for comment, including several requesting additional data or other quantitative analysis. In this regard, while we intend to respond in detail to those requests, it simply is not possible to do so within the highly abbreviated comment period. It also is impossible to evaluate the Proposal in isolation, given the need to review the Proposal in the context of other, related Commission proposals to understand their cumulative impact.[62]

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[58] 5 U.S.C. § 553(b).

[59] *Covad Communications* v. *FCC*, 450 F.3d 528, 548 (D.C. Cir. 2006).

[60] *Kern Cty. Farm Bureau* v. *Allen*, 450 F 3d 1072, 1076 (9th Cir. 2006) (internal citation omitted).

[61] *Prometheus Radio Project* v. *F.C.C.*, 652 F.3d 431, 450 (3d Cir. 2011); s*ee also Florida Power & Light Co.* v. *U.S.*, 846 F.2d 765, 771 (D.C. Cir. 1988) (affirming that the APA's notice provisions require agencies "not only [to] give adequate time for comments, but also must provide sufficient factual detail and rationale for the rule to permit interested parties to comment meaningfully").

[62] We note that the Commission has recently proposed several rules imposing new, substantive requirements on private fund advisers, as well as a number of rules that will indirectly affect them. *See,*

IV. The Proposal's qualitative tests must be substantially overhauled to be workable and consistent with the statute.

The Proposal identifies three types of activities (each a "**Qualitative Test**") that the Commission considers to have liquidity-providing effects to other market participants, and would require firms engaging in such activities to register as dealers or government securities dealers. We respectfully submit that, for the reasons described below, Qualitative Tests 1 and 2 (defined below) are unworkable as proposed and unable to be modified in a way that would be salvageable, and should not be included in any final rule. Of particular concern is the possibility that efforts to avoid inadvertently triggering these vague and overbroad tests would foreclose certain investment and trading strategies and interfere with advisers' fiduciary and best execution obligations. If the Commission proceeds to any final rule, it should replace these tests with a test for market-maker status that incorporates traditional definitions of market-maker activity, potentially supplemented by an amended version of Qualitative Test 3 (defined below), if deemed necessary.

A. The Commission should eliminate Qualitative Test 1, which captures a person routinely making roughly comparable purchases and sales of the same or substantially similar securities in a day.

Under the Proposal, a person would be required to register as a dealer or government securities dealer if that person "routinely mak[es] roughly comparable purchases and sales of the same or substantially similar securities in a day."[63] In general, we believe that this Qualitative Test ("**Qualitative Test 1**") is inconsistent with the statutory definitions of "dealer" and "government securities dealer" as interpreted by the Commission and courts over many decades[64] because it fails to, for example, take into account the manner in which persons interact with the market that have historically been indicative of dealer status, such as facilitating customer trades or providing quotes or otherwise holding oneself out as a market maker or other dealer.

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e.g., Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews, 87 Fed. Reg. 16,886 (Mar. 24, 2022), available at: https://www.govinfo.gov/content/pkg/FR-2022-03-24/pdf/2022-03212.pdf; Cybersecurity Risk Management for Investment Advisers, Registered Investment Companies, and Business Development Companies, 87 Fed. Reg. 13,524 (Mar. 9, 2022), available at: https://www.govinfo.gov/content/pkg/FR-2022-03-09/pdf/2022-03145.pdf; Amendments to Form PF to Require Current Reporting and Amend Reporting Requirements for Large Private Equity Advisers and Large Liquidity Fund Advisers, 87 Fed. Reg. 9,106 (Feb. 17, 2022), available at: https://www.govinfo.gov/content/pkg/FR-2022-02-17/pdf/2022-01976.pdf; Short Position and Short Activity Reporting by Institutional Investment Managers, 87 Fed. Reg. 14,950 (Mar. 16, 2022), available at: https://www.govinfo.gov/content/pkg/FR-2022-03-16/pdf/2022-04670.pdf. Given the short comment periods on all of these proposals, there is insufficient time to conduct a thorough analysis of the Commission's economic analysis, let alone conduct our own study of the costs and benefits of the proposals when considered as a whole.

[63] Proposing Release at 23,066.

[64] *See, supra*, Section II.

Furthermore, Qualitative Test 1 would encompass various forms of regular course trading (not dealing activity), such as merely selling short (or buying) and then buying back (or selling) an ETF as an intraday hedge to overall market moves, buying and selling securities as part of intraday cash management activities, or ETF or other arbitrage trading. We have considered this proposed test and strongly believe that it will be unworkable for market participants—as described in detail below—and we therefore urge the Commission not to include Qualitative Test 1 in any final rule.

1. Routinely

The Proposal states that routinely "means more frequent than occasional but not necessarily continuous."[65] This standard is unclear, defined with reference to another undefined concept ("occasional") and distinguished from a concept ("continuous") that market participants actually understand and have experience applying. It would ultimately be unworkable for market participants who will have to make subjective determinations, on at least a daily basis, about whether they are "routinely" engaging in the activity described in Qualitative Test 1. While the Proposal explains why the Commission did not use the more familiar qualifier "continuous" (but query, was "nearly continuous" considered? Or "regular"?), it does not offer a satisfactory alternative.

2. Roughly comparable

The Proposal provides that "roughly comparable" is intended to capture "purchases and sales similar enough, in terms of dollar volume, number of shares, or risk profile, to permit liquidity providers to maintain near market-neutral positions by netting one transaction against another transaction."[66] The "roughly comparable" standard does not require purchases and sales to be exactly the same and also does not require full netting of positions.[67] While the Commission states that it is not providing for a bright-line test, its economic analysis "assumes [that] a daily buy-sell imbalance between two identical or substantially similar securities, in terms of dollar volume, below 10% or, alternatively, 20%, may be indicative of purchases and sales that are 'roughly comparable.'"[68]

We believe that "roughly comparable" is also unclear as drafted and will cause confusion for market participants. Indeed, determining whether this standard has been met will be just as uncertain for market participants as it was for the Commission in its economic analysis. We respectfully submit that, even if the Commission were to provide additional guidance—for example, by incorporating the standard provided for in the economic analysis—that would not salvage this test because any such quantitative standard could not account for differences across different types of securities and markets. In this regard, the relatively wide buy-sell imbalance

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[65] Proposing Release at 23,066.

[66] *Id.* at 23,066.

[67] *Id*.

[68] *Id.* at 23,066 n.136.

figures used in the Proposal's economic analysis do not come close to fitting the "near market-neutral" standard set forth in the preamble (for that, closer to 1% or 5% would be more apt).

3. Same or substantially similar

Qualitative Test 1 applies to trading activity that occurs in the "same" or "substantially similar" securities.[69] Securities that are "the same" are those that are "of the same class and hav[e] the same terms, conditions, and rights."[70] The Commission notes that determining whether securities are "substantially similar" would be a facts-and-circumstances analysis involving a variety of factors, including whether: "(1) [t]he fair market value of each security primarily reflects the performance of a single firm or enterprise or the same economic factor or factors, such as interest rates; and (2) changes in the fair market value of one security are reasonably expected to approximate, directly or inversely, changes in, or a fraction or a multiple of, the fair market value of the second security."[71]

We respectfully submit that this standard—particularly the "substantially similar" portion—is fatally arbitrary and vague. Not only is the standard unclear, but the enumerated factors that are supposed to aid market participants in applying the standard would themselves require subjective determinations—for example, it is not always clear whether changes in the fair market value of one security are "reasonably expected" to approximate changes in the fair market value of another security.[72] For these reasons, we understand that our members, in attempting to understand how the rules would work in practice, have found it practically impossible to apply this standard to their own trading activity.

4. In a day

Qualitative Test 1 would apply to market participants who make purchases of the same or substantially similar securities "in a day." The Commission explains that this element is intended "to distinguish dealer liquidity providers from other market participants who may contribute liquidity to the market periodically but not in the repeated, routine—and often relied upon—manner of liquidity providers."[73] We are concerned that this standard is too broad, and that market participants who, for example, merely complete one sale and one purchase of the same

[69] *Id.* at 23,067.

[70] *Id.*

[71] *Id.*

[72] We also note that the enumerated nonexclusive examples of "substantially similar" securities are themselves unclear. For instance, the example with respect to buying and selling Treasury securities notes that the purchase and sale would be substantially similar if the two securities are "in the same maturity range" and provides a six-month difference in tenor as an example. It is not clear, however, if a larger maturity difference (*i.e.*, 1 year or 2 year), but with respect to longer-dated Treasuries, would also be deemed substantially similar. Also, one of the examples, regarding buying a put and selling a call, could occur as part of a common non-dealer strategy, such as a reverse conversion trade.

[73] *Id.* at 23,067.

securities in one day would be captured. But such a day trader is almost certainly not a dealer. The standard could also cause parties arbitrarily to delay certain purchases or sales to the following day simply to avoid being pulled into the test.

B. The Commission should eliminate Qualitative Test 2, which captures a person routinely 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.

The second Qualitative Test ("**Qualitative Test 2**") would deem persons who "routinely express[] 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" to be dealers or government securities dealers.[74] As we lay out in detail below, several aspects of this test are confusing and ambiguous, and we therefore believe that this test should not be included in any final rule. We are concerned, for example, that this rule require a firm that enters a buy limit order in one security in the morning one day and then enters a sell limit order in a different security in the afternoon on that day could become subject to the dealer registration requirements.

1. Routinely

We have the same concerns with respect to the application of the "routinely" element of this test as noted in the discussion of Qualitative Test 1, above.

2. Trading interests

Rather than using a more familiar and less open-ended term such as "quotation," the Commission has proposed to apply Qualitative Test 2 to "trading interests," which it has defined in another recent rule proposal to mean "an order, as defined in paragraph (e) of [Rule 300 of Regulation ATS] or any non-firm indication of a willingness to buy or sell a security that identifies at least the security and either quantity, direction (buy or sell), or price."[75] The Commission notes that it has proposed to use the term "trading interest," as opposed to "quotation," in order to "reflect the prevalence of non-firm trading interests offered by market places today, and account for the varied ways in which developing technologies permit market participants to effectively make markets."[76]

The use of "trading interests" in the context of Qualitative Test 2 is inappropriate and would capture trading-related activity that is not indicative of dealer activity. In particular, non-firm indications of a willingness to buy or sell (for example, someone making a request in the

[74] *Id*.

[75] *Id.* at 23,068. 17 C.F.R. 242.300(e) defines an "order" to mean "any firm indication of a willingness to buy or sell a security, as either principal or agent, including any bid or offer quotation, market order, limit order, or other priced order." *Id.* at n.151.

[76] *Id.* at 23,068.

request-for-quote context) may not (and often do not) result in executed transactions even if the price offered to buy or sell is matched in the market. Furthermore, we believe it will be challenging, if not impossible, to assess whether a non-firm willingness to buy or sell is actually "at or near the best available price" because firms offering those non-firm trading interests need not execute on them if matched. And even putting aside these ambiguities, we question why merely expressing trading interests on both sides of the market and seeking to get the best price when doing so is indicative of dealing activity when nearly any active investor or trader might engage in this activity just to get best execution, for example when buying one security or selling another; unless this test was limited to *simultaneous* quotations on both sides of the market for the *same* security, it would be extraordinarily overbroad. For these reasons, this aspect of Qualitative Test 2 is unworkable as proposed.

3. Both sides of the market

We are particularly concerned that Qualitative Test 2, as written, could be read to prevent firms from using an order book trading protocol to trade actively by posting resting offers (when they want to sell) and bids (when they want to buy). This is because the test does not require quotations or other trading interests to be expressed on both sides of the market simultaneously or even with respect to the same security. Preventing buy-side firms from resting orders in an order book would be inconsistent with Commission efforts to promote order book trading by firms in other contexts (*e.g.*, with security-based swap execution facilities) and would result in this test capturing trading that is not consistent with dealer activity.[77]

4. Best available prices

The Proposal provides that "best available prices on both sides of the market" is intended to describe "the activity of liquidity-providing dealers, which help determine the spread between the best available bid price and the best available ask price for a given security."[78] But not only dealers seek to trade at the best available prices; investors do so as well, indeed, an adviser is bound by a best execution duty that obligates it to seek to do so.

In addition, given that the test is not limited to liquid, exchange-traded markets, and the Proposal does not even define what the term "market" means, we are concerned that the test could be interpreted to capture markets where it may not be feasible or possible to determine the best available prices in certain markets. For example, determining whether a firm is expressing trading interests at or near the best available prices on both sides of an illiquid over-the-counter market is different, and more challenging, than doing so with respect to the market for a liquid, exchange-traded equity security. This test would ultimately require firms to constantly determine whether they are expressing trading interests at the best available price across all markets in which they trade, which is onerous at best, and more likely impossible.

[77] *See* SEC Release No. 34-94615, 87 Fed. Reg. 28,872 (May 11, 2022).

[78] Proposing Release at 23,068.

5. Accessible to other market participants

The final element of proposed Qualitative Test 2 is that the trading interests are "communicated and represented in a way that makes them accessible to other market participants."[79] The Commission does not explain the terms that constitute this element, including what it means for trading interests to be "communicated," "representative" and "accessible," and what is meant by "other market participants." For example, it is not clear under the Proposal whether trading interests made available to a limited group of participants via an RFQ would (or should) trigger Qualitative Test 2, versus trading interests published on a broadly accessible order book. The vagueness of this element results in a test that market participants cannot apply with any confidence and will likely result in inconsistent and arbitrary application by the Commission.

In addition, this element could encourage market participants to choose execution venues and order types that are not transparent or accessible, such as trading in dark pools or placing iceberg orders. It is not clear why the Commission would wish to create such incentives.

C. In lieu of Qualitative Tests 1 and 2, the Commission could adopt a test defining a person acting as a bona fide market maker as a dealer.

The Commission has long considered a person acting as a market maker to be engaged in dealer activity.[80] The parameters of "market maker" activity are also relatively clear and well understood. For example, Section 3(a)(38) defines a "market maker" with reference to whether a person, with respect to a security, "holds himself out (by entering questions in an inter-dealer communications system or otherwise) as being willing to buy and sell such security for his own account on a regular or continuous basis."[81] The Commission has also provided guidance regarding what constitutes *bona fide* market-making activity in the context of Regulation SHO, such as continuous quotations that are at or near the market on both sides and that are communicated and represented in a way that makes them widely accessible to investors and other broker-dealers.[82] Although the Proposal indicates that it is adopting a different test from Regulation SHO for "dealer" status, in our view the Regulation SHO test is clearer to apply and still likely to capture the sort of trading activity identified as the basis for the Proposal.

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[79] *Id*.

[80] *See, e.g.,* text accompanying note 42, *supra*.

[81] The Commission has also stated that a market maker engaged in bona-fide market making is a "broker-dealer that deals on a regular basis with other broker-dealers, actively buying and selling the subject security as well as regularly and continuously placing quotations in a quotation medium on both the bid and ask side of the market." *See, e.g.*, SEC Release No. 34-32632 (July 14, 1993), 58 Fed. Reg. 39,072, 39,074 (July 21, 1993).

[82] *See* Proposing Release at 23,068 n.157.

D. *If the Commission wants to expand beyond a* bona fide *market maker test, then it should supplement that test through a modified version of Qualitative Test 3.*

The third Qualitative Test ("**Qualitative Test 3**") would identify "earning 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" as a pattern of behavior indicative of dealer status.[83] The Commission explains that this standard is informed by the fact that, unlike traders, dealers "trad[e] in a manner designed to profit from spreads or liquidity incentives, rather than with a view toward appreciation in value."[84] While the Commission declined to propose a bright-line test with respect to Qualitative Test 3, the Proposal makes clear that a person that derives the majority of its revenue from capturing bid-ask spreads, buying at the bid and selling at the offer, or capturing incentives offered by trading venues would "likely" be within the scope of the Proposed Rules.[85]

Unlike Qualitative Tests 1 and 2, Qualitative Test 3 could be workable, subject to the following clarifications:

1. <u>Revenue</u>

Qualitative Test 3 focuses on revenue earned by market participants, rather than profits, despite the fact that the Commission acknowledges that dealers trade in a manner designed to *profit* from (and not merely earn revenue from) spreads or liquidity incentives. We respectfully submit that it would be more appropriate for this test to be tied to profit, since dealers are in the business of profiting from their market-making activities and are unlikely to be (or stay) engaged in markets if they are not profiting off of dealer-like activities.[86] In fact, we believe that a firm that is engaged in such activities, but fails to earn profits in doing so, is more indicative that such market participant is a trader, rather than a dealer.

2. <u>Trading venue</u>

The Proposal states that "trading venue" includes "a national securities exchange or national securities association that operates an SRO trading facility, an ATS, an exchange market maker, an OTC market maker, a futures or options market, or any other broker or dealer-operated platform for executing trading interest internally by trading as principal or crossing orders as agent," in line with the Commission's recent ATS proposal.[87] Noting recent technological advances that have led to the rise of non-exchange trading platforms, the Commission states that

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[83] *Id.* at 23,069.

[84] *Id.*

[85] *Id.*

[86] Profit making is a standard used in similar circumstances as well. For example, the Volcker Rule refers extensively to "profits" in expounding its limitations on bank activities, as opposed to using revenue. *See* 12 C.F.R. § 351(d)(6)(ii)(A) (defining "restricted profit interest").

[87] Proposing Release at 23,069 & n.162.

the Proposal is "designed to capture dealer activity wherever that activity occurs….[T]he particular trading venue matters less than the fact that a market participant provides liquidity on it."[88]

We appreciate the need for securities regulation to take account of technological and other changes in the markets. However, we are concerned that the proposed breadth of the term "trading venue," could present implementation challenges to market participants. A more workable test that would capture the most significant trading activity and reduce the compliance burdens on market participants would be limited to the most liquid trading venues, including those where liquidity incentives are most likely to be offered and where trading to profit from the spread occurs most often. In our view, therefore, we believe that Qualitative Test 3 should be limited to national securities exchanges and ATSs. This approach would avoid difficult and unworkable line-drawing questions, such as when pricing offered by an OTC market maker to its customer would constitute an "incentive" captured by the rule.

V. The Proposal's quantitative test for government securities dealers is inappropriate, exceeds the Commission's statutory authority, and would chill liquidity-providing activities in government securities markets.

The Proposal also sets forth a quantitative standard for government securities dealers (the "**Quantitative Test**"). The Quantitative Test is a bright-line test under which a person would be automatically deemed a government securities dealer if that person "[i]n each of 4 out of the last 6 calendar months, engaged in buying and selling more than $25 billion of trading volume in government securities," regardless of whether that person meets any of the three qualitative standards discussed above.[89]

We have significant concerns with respect to the proposed Quantitative Test. As noted above, the Commission and courts historically have not applied a bright-line, single-factor test in connection with determining dealer status and have acknowledged that the dealer-trader distinction depends on the particular facts and circumstances of any given scenario.[90] In particular, the Commission is not authorized to enforce a bright-line, solely quantitative dealer

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[88] *Id.* at 23,070.

[89] *Id.* at 23,071.

[90] *See* Adoption of Rule 15ba2-1, Related Form Msd, Rule 15ba2-2 and Temporary Rule 15ba2-3(T) Relating to the Registration of Municipal Securities Dealers Under Section 15b(A) of the Securities Exchange Act of 1934; Adoption of Temporary Rule 15a-1(T) Relating to the Registration of Municipal Securities Brokers and Dealers Under Section 15 of the Act; and Delegation of Authority to the Staff of the Commission, SEC No. 34-11742 (Oct. 15, 1975), 40 Fed. Reg. 49772, 49773 (Oct. 24, 1975) ("[I]t would appear that the nature of a bank's activities, rather than the volume of transactions or similar criteria, are of greater relevance in determining when a bank is a municipal securities dealer.").

test—Congress is clear when it intends to provide an agency with such authority and Congress has not done so here.[91]

Even if the Commission did have such authority (which it does not), we respectfully submit that it would be unwise—and potentially harmful to government securities markets—for the Commission to enact the Quantitative Test as proposed.

The proposed $25 billion threshold is arbitrary and not indicative of market-making (or even significant, relative to other firms) activity absent other indicia of dealer-like activity such as those applied by the SEC and courts in the traditional dealer-trader analysis. Furthermore, while we do not believe that any dollar threshold would be appropriate, we note that the proposed $25 billion threshold is clearly inappropriate, because it represents a miniscule fraction of the average monthly transaction volume in the Treasury market.[92]

The Quantitative Test would undoubtedly capture a significant amount of trading that does not represent or approximate dealer activity. For example, a market participant that engages in multiple transactions of buying and then immediately selling government securities, aggregating to more than $25 billion of average monthly transaction volume, would be treated the same as a market participant that primarily buys government securities above the dollar threshold during the applicable month to express an investment position and then later sells such government securities after at least some holding period. The latter market participant clearly is not engaged in purchasing *and* selling activity, as required by the Exchange Act and existing rules and guidance.[93] These concerns demonstrate how a blunt, un-nuanced bright-line test that cannot take into account the facts and circumstances of a particular scenario can result in inappropriate and unintended outcomes.

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[91] For instance, in the definition of a security-based swap dealer, Congress explicitly noted that "the Commission shall exempt from designation as a security-based swap dealer an entity that engages in a de minimis quantity of security-based swap dealing…." 15 U.S.C. § 78c(a)(71)(D). The Commission then acted on Congress's delegation of authority by promulgating quantitative de minimis thresholds for the definition of security-based swap dealer in 2013. 17 C.F.R. § 240.3a71-2.

[92] By one estimate, the average daily transaction volume in the Treasury markets in 2022 year-to-date was $677 billion, which equates to approximately $13.5 trillion average monthly transaction volume (assuming 20 trading days per month). $25 billion represents just 0.18% of monthly trading volume. *See* SIFMA, US Treasury Securities Statistics (May 5, 2022), available at: https://www.sifma.org/resources/research/us-treasury-securities-statistics/#:%7E:text=Average%20Daily%20Trading%20Volume%20(as,trillion%2C%20%2B8.9%20Y%2FY.

[93] To take another example, treasury basis trading generally involves longer average holding periods, does not involve buying and selling the same or substantially similar instruments on an intraday basis, and does not have as its purpose to provide liquidity to other trading firms in exchange for a profit. And yet, funds engaged in treasury basis trading could exceed the proposed $25 billion threshold and be required to register as government securities dealers as a result, even though their activity does not represent or approximate dealer activity. *See also* note 51, *supra*.

The Proposal also does not seem to have considered whether other qualitative and quantitative factors, alone or in combination, might be more indicative of government securities status. Such factors could include the distinction between price taker versus price maker activity.

Furthermore, the Commission has not adequately considered the consequences that the Quantitative Test could have on government securities markets. The bright-line threshold will inevitably decrease certain firms' participation in the Treasury markets in order to avoid dealer status, may lead some to leave the market altogether, and may discourage new firms from entering. This could lead to further concentration in the market, decrease market resilience and stability, and lead to increased systemic risk. Liquid Treasury markets are essential to the proper functioning of U.S. and global markets, and reduced participation in the Treasury markets will lead to less liquidity and greater volatility, which could result in significant damage to the financial markets and the real economy in the United States. Other regulators are deeply concerned about U.S. Treasury market liquidity. In its May 2022 Financial Stability Report, the Board of Governors of the Federal Reserve System noted that price spreads of the most recently issued Treasury securities over previously issued comparable-maturity Treasury securities widened, reflecting a higher liquidity premium.[94] The report also identified emerging threats to the market, such the possibility that "a sharp rise in interest rates could lead to higher volatility [and] stresses to market liquidity."[95] Particularly given the current inflationary environment, as well as the direct impact on the Treasury market of quantitative tightening by the Federal Reserve, we think these concerns should not be overlooked.

In light of such concerns, the Commission should act with due caution and appropriate care before promulgating any final rules that could exacerbate liquidity concerns in the Treasury markets. We also question why the Quantitative Test is necessary, considering that one or more of the Qualitative Tests is highly likely to encompass participants engaged in material liquidity-providing trading in the Treasury market. We therefore respectfully request that the Commission not include the Quantitative Test in any final rule.

VI. The Commission should define the term "person" to recognize disaggregation by independent portfolio managers.

The Proposal appears based on an assumption that all trading activity taking place within a single legal entity or commonly controlled group of legal entities takes place on an integrated and coordinated basis. However, it is quite common that a single entity (including a fund) or group of entities engage in trading through substantially (for all relevant purposes) independent portfolio managers. For example, an investment adviser might delegate trading authority among multiple portfolio managers (sometimes separate sub-advisers, but sometimes part of the same investment adviser), who, in turn, trade independently of each other. If the trading activity of these independent portfolio managers were aggregated with each other, the aggregate appearance could be viewed, inappropriately, as being in the nature of market making as discussed above. For example, if one manager were pursuing a long-only strategy and another were pursuing a

[94] Financial Stability Report at 7-8.

[95] *Id.* at 56.

short-only strategy, the combined trading activity of the two managers might coincidentally but inadvertently trigger Qualitative Test 1 for roughly comparable purchases and sales of the same or substantially similar securities.

To avoid this issue, the Commission should adopt a definition of "person" that treats separately trading activity conducted by separate decision-makers without coordination of trading or cooperation among or between them. This treatment would be consistent with the treatment of truly separate accounts for other securities law purposes.

VII. The Commission should not require aggregation of separate persons' trading activity absent evasion.

As noted above, the Exchange Act defines a "dealer" and "government securities dealer" as a person engaged in the business of buying and selling securities for its "own account."[96] The Proposal would define "own account" to require aggregation among accounts held in the name (or for the benefit) of commonly controlled entities, including accounts held by a registered investment adviser for its clients where the adviser has certain voting or economic rights or where the clients are trading as part of a parallel account structure.[97]

In the Commission's view, this aggregation requirement "recognizes that corporate families and entities may be organized in various structures" and the proposed definitions of both "own account" and "control" are "designed to focus on the trading activity occurring at the firm or legal-entity level or the trading activity that is being employed on behalf of, or for the benefit of, the entity, and limit the registration burden to those entities engaged in dealer activity."[98] The Commission also noted that the definitions are drafted to deter evasion of the Proposal in the

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[96] 15 U.S.C. § 78c(a)(5)(A) (dealer); 15 U.S.C. § 78c(a)(44) (government securities dealer).

[97] Specifically, the Proposal would define a person's "own account" as any account that is (1) held in the name of the person, (2) held in the name of a person over whom that person exercises control or with whom that person is under common control, subject to the exclusions detailed below, or (3) held for the benefit of the persons identified in the previous two categories. Three types of accounts would be excluded from the "own account" definition: (1) an account in the name of a registered broker, dealer or government securities dealer, or an investment company registered under the Investment Company Act; (2) with respect to an investment adviser registered under the Investment Advisers Act of 1940 ("**Advisers Act**"), an account held in the name of a client of the adviser *unless* the adviser controls the client as a result of the adviser's right to vote or direct the vote of voting securities of the client, the adviser's right to sell or direct the sale of voting securities of the client, or the adviser's capital contributions to or rights to amounts upon dissolution of the client; and (3) with respect to any person, an account in the name of another person that is under common control with that person solely because both persons are clients of an investment adviser registered under the Advisers Act, *unless* those accounts constitute a parallel account structure. The Proposal would incorporate the definition of "control" under Exchange Act Rule 13h-l in determining the accounts that should be aggregated for the purpose of this definition. The Proposal also would use the Form PF definition of "parallel account structure."

[98] Proposing Release at 23,074.

form of market participants changing their corporate structures for the purpose of avoiding registration.[99]

We generally question whether it is appropriate, in the context of the "dealer" and "government securities dealer" definitions, to adopt such broad aggregation rules. We are not aware of any judicial or agency precedent interpreting the phrase "own account" in any similar manner. Rather, market participants have traditionally understood the phrase to refer to trading done by the particular person that is the prospective object of the dealer or government securities dealer definition; this comports with regular-course dictionary understandings of the term "own" to refer to something belonging to or done by a particular person.[100]

Furthermore, as a policy matter, mere economic interest or control rights with respect to different entities does not necessarily connote pursuit of coordinated trading across those entities. Indeed, as noted above in Section VI, it is perhaps more common for trading to take place independently, such that aggregation would more likely result in an inadvertent and unwarranted expansion of dealer registration to capture independent trading activities that only coincidentally satisfy the Proposal's various tests.[101]

On the other hand, we understand the Commission's concerns about evasion. We respectfully submit that the Commission can address those concerns through a more tailored measure. Specifically, the Proposal should be modified to require aggregation among commonly controlled entities solely in circumstances where such entities, acting together or at the direction of a person controlling them both, engage in coordinating trading activity willfully structured to evade the rule.

VIII. The Commission should extend the Proposal's compliance deadlines.

The Proposal provides that a market participant whose activities, prior to the effectiveness of any final rule, fall within the scope of the Proposal would be required to register

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[99] *Id.*

[100] *See* Cambridge Dictionary (definition of "own").

[101] We also note that the Proposal's aggregation rule would also inadvertently capture other scenarios not legitimately within the scope of dealer registration. For example, the intersection of the aggregation standard reflected in the proposed "own account" definition and the territorial scope of the Exchange Act is not clear. If a U.S. parent company owns a foreign subsidiary that engages in securities trading activity either in compliance with SEC Rule 15a-6 or without the jurisdiction of the United States, such that the subsidiary is not subject to registration standing alone, would that subsidiary's trading activity nonetheless be attributed to the parent company and thus subject it to registration? This result is illogical and, if adopted, would essentially rule out the ability for U.S. companies to conduct securities-trading operations internationally on a level playing field with foreign competitors. Similarly, what if a person owns a bank that engages in activities excepted from the "dealer" definition, such as purchases or sales for investment purposes for accounts for which the bank acts as a trustee or a fiduciary? Would that bank's exempt trading activity nonetheless be attributed to the parent company? This result would be illogical as well. If the Commission retains the proposed aggregation rule, then all exempt or excluded entities should not be subject to aggregation by those controlling or under common control with them.

with the Commission within one year following the effective date of any final rule.[102] However, the Proposal does not provide a compliance period for market participants whose activities start to require registration following the effective date of any final rule.[103]

We strongly urge the Commission to extend the proposed one-year compliance period. The Proposal's requirements are complex and we understand that firms will need to expend significant time, resources, and effort to understand and apply them. Firms that determine that registration is necessary after an analysis of their trading activity will then need additional time to prepare a Form BD and otherwise prepare to comply with the Commission's dealer regulations. We believe that a 36-month transition period following the effectiveness of any final rule would be more appropriate.

We also recommend that the Commission provide the same transition period for market participants whose activities would require registration following the effective date of any final rules. Treating such market participants differently from those conducting in-scope activity upon the effective date of the final rule would raise several ambiguities. For example, if a person satisfied the Quantitative Test not long prior to the finalization of the rule, then fell just below that test's threshold during the six months encompassing the rule's effective date, would the person be eligible for the transition period? What if, just following the rule's effective date, a person restructured trading activity falling within the scope of the final rule to occur through a new legal entity? This bifurcated approach also would only give market participants 60 days to determine whether they fall within scope of the final rules, which would be insufficient given the many vague and novel concepts that might be reflected in a final rule. It will be far easier and fairer to provide a common transition period for all market participants.

[102] Proposing Release at 23,062.

[103] *Id.*

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We appreciate the opportunity to provide our comments to the Commission regarding the Proposal, and we would be pleased to meet with the Commission or its staff to discuss our comments. If the staff has questions or comments, please do not hesitate to call Matthew Daigler, Vice President & Senior Counsel, or the undersigned at [redacted]

Respectfully submitted,

/s/ Jennifer W. Han

Jennifer W. Han
Executive Vice President
Chief Counsel & Head of Global Regulatory Affairs

cc: The Hon. Gary Gensler, SEC Chair
The Hon. Hester M. Peirce, SEC Commissioner
The Hon. Allison Herren Lee, SEC Commissioner
The Hon. Caroline A. Crenshaw, SEC Commissioner
Dr. Haoxiang Zhu, Director, Division of Trading and Markets
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