May 27, 2022

By Electronic Submission

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

Re: Further Definition of “As a Part of a Regular Business” in the Definition of Dealer and Government Securities Dealer, File Number S7-12-22

Dear Ms. Countryman:

Thank you for the opportunity to comment on the Securities and Exchange Commission’s (“SEC” or “Commission”) proposal to provide “Further Definition of ‘As a Part of a Regular Business’ in the Definition of Dealer and Government Securities Dealer”.¹

Two Sigma² is an active member of the Managed Funds Association and the Alternative Investment Management Association and fully supports the letters they have submitted regarding the Proposal, but we are writing separately today as we have grave concerns that the Proposal will have a significant negative impact on investors by forcing private fund advisers to either (i) modify their investment strategies to limit trading in U.S. Treasuries and avoid other commonplace trading activities in order to not become dealers, or (ii) abandon their trader status in the market, transform their business to become broker-dealers trading for their own account, and redeem at least some third-party investor capital as a result of that change. In either case, the Proposal will result in fewer and worse options for investors, lead to a less diverse marketplace, harm price discovery, and remove significant sources of liquidity from equity and U.S. Treasury markets.

Two Sigma includes two institutional private fund advisers that specialize in process-driven, systematic investment strategies and techniques, Two Sigma Investments, LP and Two Sigma Advisers, LP

² Two Sigma is a group of financial sciences companies. We combine rigorous inquiry, data analysis, and invention to solve challenges in investment management, securities, insurance, private equity, and venture capital. Founded in 2001, Two Sigma employs over 1600 people, and has offices in New York, Houston, Portland, London, Tokyo, Hong Kong, and Shanghai.
(collectively, “we” or “our”). We perform quantitative analysis and leverage technology to develop and implement investment, portfolio, risk management, and execution strategies and techniques on behalf of our investors. Two Sigma also includes an SEC- and FINRA-registered broker-dealer, Two Sigma Securities, LLC (“TSS”), which operates a wholesale market making business and an options market making business, in addition to other liquidity providing businesses in equities, futures, and ETFs across the globe. With a number of registered investment advisers and a broker-dealer since 2009, Two Sigma has thought carefully about the appropriate home for each business line and has been aided by the longstanding and well-trodden regulatory landscape regarding dealer registration and its associated costs and benefits.

Over the years, the industry has come to rely on decades of jurisprudence and SEC guidance that established a workable framework to determine if registration as a broker-dealer is warranted. A key tenet in that framework is that the focal point of analysis is the entity’s entire “regular business”, so that any one incidental activity is not dispositive. Notably, gross trading volumes are not a factor; for decades it has been perfectly appropriate to be a large trader without having to register as a broker-dealer. The guidance also does not require contorting the concept of an entity’s “regular business” by pretending that it engaged in all the other activities performed by affiliates controlled by, controlling, or under common control with such entity. In this manner, the framework wisely recognized that entities, and not groups of entities under common control, are eligible to register as broker-dealers and that registration is a very significant undertaking.

The Proposal would eviscerate the decades-old dealer-trader framework in three fundamental ways. First, the Proposal would change the focus of analysis from an entity’s whole business to whether any strategy employed by the entity engages in certain enumerated activities. Second, the enumerated activities that would trigger registration are described in broad terms that would cover commonplace investment strategies used by many private fund advisers. Third, the Proposal would require aggregation of activities among all entities controlled by, controlling, or under common control with any person engaged in the prescribed conduct (subject to very limited exceptions). This approach seemingly results in a minor part of the strategies pursued on behalf of a single fund tainting an adviser with dozens of other funds, as well as that adviser’s affiliates.

In this manner, the Proposal hollows out the trader side of the dealer-trader distinction, which will have significant negative consequences for investors and the market. Faced with either becoming dealers or modifying their strategies, advisers will modify their strategies to constrain their trading of Treasuries and eliminate short-horizon trading strategies or migrate them to dealers. Whatever the change, the result will not only reduce liquidity in Treasury and equity markets, but more importantly, it will limit
investors’ access to strategies and trading approaches that help performance by diversifying their portfolio and that are essential to improve execution quality given the microstructure of our markets.

If adopted as proposed, the SEC’s new dealer regime will be most harmful to investors in actively managed private funds. In particular, we are concerned that this Proposal will negatively impact investors by reducing or eliminating their exposure to beneficial strategies and techniques. The Proposal would also fundamentally alter the way private fund advisers trade in the market and create a two-tiered system where only broker-dealers can fully engage in the market and investment advisers are relegated to a more passive role.

Private fund advisers are not the unregistered and largely unregulated entities the SEC indicates it is seeking to regulate with this Proposal. We are directly and rigorously overseen by the SEC, the Commodity Futures Trading Commission, and National Futures Association in the United States. Two Sigma’s work around the world also results in its personnel and trading being regulated by the United Kingdom’s Financial Conduct Authority, the European Securities and Markets Authority, Luxembourg’s Commission de Surveillance du Secteur Financier, Hong Kong’s Securities and Futures Commission, and the China Securities Regulatory Commission among others. We and our peers are very highly regulated and the concerns raised in the Proposal suggesting that the regulation of investment advisers and private funds is somehow less effective or rigorous than broker-dealer or registered investment company regulation is utterly unfounded and does not justify the Proposal.

Entities within the Two Sigma group are subject to either U.S. broker-dealer or private fund adviser regulation, so we can attest that neither is inherently “stronger” than the other. However, operating a private fund adviser business as a broker-dealer is untenable given the negative impact such a registration would have on investors. Two Sigma engages in a significant amount of market activity through TSS, but it is not feasible to advise private funds that are broker-dealers given the way such registration fundamentally changes an entity’s regulatory status in the marketplace and the burdens that structure would place upon investors. The Managed Funds Association details some examples of these burdens in its own letter in response to the Proposal, but by way of illustration we note that capital contributions into a broker-dealer cannot be withdrawn for a period of one year unless otherwise permitted in writing by FINRA pursuant to FINRA Rule 4110; investors in a broker-dealer are exposed to all the operating costs and liabilities of the broker-dealer, instead of a pre-negotiated fee and incentive allocation based on the amount invested; the tax regime for income from funds is markedly different than for a broker-dealer; a fund that becomes a broker-dealer loses a broad range of important protections as a “customer” for purposes of many SEC and Financial Industry Regulatory Authority (“FINRA”) rules, including customer asset protection under SEC Rule 15c3-3, as well as FINRA rules regarding mark-ups, fair prices, and trading ahead. Similarly, an investment adviser that transformed
into a broker-dealer would cease to be a fiduciary under the Investment Advisers Act or subject to the salutary disclosure regime of Form ADV.

Unrealistically, the Proposal seems to contemplate a world where traders will opt to become dealers instead of modifying their strategies or reducing their activity in the market. We respectfully submit that the most likely outcome is exactly the opposite as becoming a broker-dealer is untenable for most private fund advisers. Strategies that are potentially implicated will be abandoned by private fund advisers, and the United States Treasury will see liquidity in its offerings drop as advisers significantly constrain their activities to avoid registering as government securities dealers.

Such an outcome will harm pension plans, institutional investors, the United States Treasury, and the markets more generally because private fund advisers will refrain from engaging in strategies that might be swept into the SEC’s expansive, new “dealer” regime.

In the sections below, we provide further details regarding our concerns.

I. The Proposed Quantitative Threshold to Require Registration as a Government Securities Dealer Will Capture Far More Private Funds Than the Proposal Anticipates and Exceeds the SEC’s Rulemaking Authority

A. The Threshold is Unrealistically Low and Will Capture Far More Private Funds and Associated Advisers Than the Proposal Anticipates

The SEC’s proposed quantitative threshold for Treasuries is unrealistically low given the size of the Treasuries market and its pivotal role – Treasuries are used, for example, for cash management, to offset exposures in riskier instruments, and to facilitate investments in a broad range of assets at the heart of the U.S. economy and capital formation including mortgage-backed securities and corporate bonds.

However, the SEC indicates that very few private fund advisers will be impacted. The Proposal states that:

“[i]t is also possible that a large hedge fund could trade sufficient volumes of U.S. Treasury securities to satisfy the quantitative standard. The extent to which hedge funds may satisfy these standards is uncertain…We observe at least one hedge fund…that surpassed the quantitative standard's threshold of $25 billion in U.S. Treasuries in July 2021.”

3 Proposal at 23082.
Contrary to the SEC’s assessment, our observation of the market indicates that many non-FINRA members would likely trade sufficient volumes of Treasuries to face registration as a government securities dealer. The vast majority of this trading activity is related to risk and cash management, and not the activity the SEC states it is trying to regulate, but as a result of the unrealistically low registration threshold in the proposed quantitative criteria under Rule 3a44-2, the Proposal will functionally require any private fund adviser responsible for sizable portfolios to register as a government securities dealer simply as a result of its cash and risk management activities. The Proposal underestimates the number of impacted entities, so we ask the SEC to conduct a fulsome analysis to determine the number of the market participants that could be impacted before moving forward with a rule based on a fundamentally compromised cost-benefit analysis.

If the Commission moves forward with the rule as proposed, private fund advisers will have to reassess their strategies in light of the $25 billion threshold. Faced with becoming dealers, many advisers to private funds will modify their strategies to constrain their trading of Treasuries and other assets. For example, an adviser running multiple large fixed income strategies may decide to cap or abandon strategies that are Treasury-intensive because the adviser wants to steer clear of the dealer threshold. Similarly, advisers may replace investments in Treasury bills with more expensive money market funds to make more profitable use of their $25 billion monthly Treasury trading budget. This type of modification will be harmful to investors, but the Proposal puts advisers in an untenable position where unconstrained trading of Treasuries would be an even worse outcome for investors who will not want or be able to invest in a broker-dealer.

The Proposal incorrectly assumes that firms will not see the substantial legal and regulatory obligations of dealer registration as meaningful and will not refrain from crossing the dealer registration threshold. Instead, in practice firms will limit their trading of Treasuries which will harm investors, market liquidity, and the U.S. Treasury. That impact on the U.S. Treasury, taxpayers, and investors is not addressed in the Proposal, which is another crucial shortcoming of the Commission’s cost-benefit analysis. Based on that alone, the SEC should at a minimum reassess the Proposal and issue a revised proposal with a detailed analysis of the expected impact on market liquidity and capital formation as a result of firms seeking to comply with the new rule by modifying their investment strategies.

B. A Quantitative Threshold for Triggering Dealer Registration Exceeds the SEC’s Authority

Additionally, the SEC’s proposed definition of “as part of a regular business” in Rule 3a44-2 is problematic because it is inconsistent with the statutory definition of “government securities dealer” in Section 3(a)(44)(A) of the Securities Exchange Act. Specifically, proposed Rule 3a44-2 contemplates that government securities dealer status could be triggered merely by a person’s gross trading volume in
government securities. By defining “as part of a regular business” in this manner for government securities dealers, the Proposal is arbitrary and capricious and exceeds the SEC’s rulemaking authority because it runs counter to Congress’ definition of “government securities dealer” in Section 3(a)(44)(A).

This Proposal contravenes Congress’ intent in two key ways. First, in adopting the statutory definition of “government securities dealer,” Congress intended that the same factors used to determine if someone is a “dealer” under Section 3(a)(5) would be used to determine whether someone is a “government securities dealer” under Section 3(a)(44)(A). The SEC explicitly acknowledged this fact in footnote 42 of the Proposal, stating the term “government securities dealer” is intended to “utilize key concepts from the current definitions of ‘dealer’ and ‘municipal securities dealer.’”4 However, notwithstanding this explicit acknowledgement, the Proposal contravenes Congressional intent because it would establish two significantly different standards for determining when a person is acting as a “dealer” or “government securities dealer.” While the definition of dealer under proposed Rule 3a5-4 would be determined based on a person’s conduct, the definition of government securities dealer under proposed Rule 3a44-2(a)(2) focuses exclusively on the volume of trading the person transacts, regardless of conduct. By adopting two entirely different definitions, the SEC’s proposed rule is directly contrary to Congress’ expectation that “the principles applied in determining whether a person is a dealer...would also be applied in determining whether a person is a government securities dealer”.5

Second, the SEC’s proposed quantitative test is also inconsistent with the statutory definition of “government securities dealer” and Congressional intent because it would eliminate any consideration of whether a person, in fact, is acting as a “dealer” versus a large trader. There is no discussion anywhere in the legislative history of the definition of “government securities dealer” that Congress intended a person to trigger this definition merely by trading a certain volume of securities and, notably, the Proposal does not identify any such discussion. To the contrary, both the House Committee Report and the Senate Committee Report on the Government Securities Act of 1986 focused on a person’s conduct, not trading volume, in determining government securities dealer status.6

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6 See US Savings Association of Texas, SEC No-Action Letter (Apr. 2, 1987), which includes the following discussion of Congressional reports on the Government Securities Act (emphasis added):

Both Committee Reports also include the following example of a case in which a person would not be considered "engaged in the business" of being a government securities dealer: [a person who engages in transactions for its own account solely with government securities brokers or government securities dealers who have registered under new section 15C(a) would not, in most cases, be considered to be "engaged in the business" of being a government securities dealer, absent an indication that the person was holding itself out as a dealer in government securities, acting as an underwriter for issuers of government securities, or carrying a dealer inventory in government securities. H.R. Rep. No. 258 at 24 n.47; S. Rep. No. 426 at 19 n.36.
It is clear Congress intended that a person’s status as a “government securities dealer” would be determined based on that person’s conduct, and not purely on a quantitative volume trigger. The SEC’s proposed quantitative test for government securities dealer status is thus inconsistent with Congress’ intent that “government securities dealers” would only include persons who are engaged in “dealer” activities, such as holding themselves out as a dealer, acting as an underwriter, carrying a dealer inventory, or trading with unregistered counterparties.

As noted in a no-action letter to *U.S. Savings Association of Texas*\(^7\), the SEC Staff determined – after carefully reviewing the relevant legislative history – that because a company did not exhibit the characteristics of a dealer, “the fact that [it] engages in a high volume of government securities transactions should carry no weight in the determination of whether [the company] is a government securities dealer.” While we appreciate that a no-action letter does not have the force of a Commission statement, it is notable that in cases where SEC Staff conducted a careful analysis of the Government Securities Act, it concluded that the conduct of a person – and not the volume of securities that person trades – determines “government securities dealer” status.

In contrast to this situation where the SEC Staff carefully considered Congress’ intent in determining the scope of activities that fall within the statutory definition of “government securities dealer,” the Proposal does not contain any meaningful analysis of the Government Securities Act of 1986. In fact, the Proposal provides no legislative support for a strictly quantitative, “volume of trades” test for triggering the statutory definition of “government securities dealer.” To the contrary, the legislative support cited in the Proposal relates to the qualitative factors for determining dealer status under proposed Rule 3a5-4. This notable gap in the Proposal reinforces our view that the proposed quantitative test is inconsistent with Congressional intent and therefore would be arbitrary and capricious by going beyond the SEC’s rulemaking authority.

II. The Qualitative Thresholds Will Force Private Fund Advisers to Abandon Many Common Strategies or Move Those Strategies Into Broker-Dealers

The broad reach of the SEC’s proposed qualitative thresholds under proposed Rule 3a5-4 means that an adviser or its funds would be deemed a dealer even if the specified conduct is a minor part of a broader investment strategy. In addition to being broad, the Proposal is vague and is not sufficiently clear for advisers to rest assured that well-established investment strategies do not trigger dealer registration. For example, under the Proposal, making “roughly comparable” purchases and sales of “the same or substantially similar” securities in a day, on a “frequent” basis triggers dealer registration. The SEC

\(^7\) *Id.*
further notes that “roughly comparable” means “within a reasonable range”, and that “substantially similar” should be interpreted based on “a facts and circumstances analysis” of a nonexclusive list of factors that includes whether the transactions permit a fund to maintain a “near market-neutral position”. In light of these statements, private fund advisers will have to reevaluate investment strategies, potentially restructure funds, and cease or redirect future research efforts. Combined with the SEC’s statements in the Proposal that no private fund adviser employing both long and short strategies can be comfortable they are not dealers, this Proposal will lead to advisers facing the potential the SEC could determine they are dealers at any time for engaging in trading strategies that are commonplace among non-dealers.

These concerns are amplified here as the Proposal focuses on the effect of a firm’s trading, and not its intent. As a result, firms will abandon or significantly downgrade their efforts to pursue short-horizon and arbitrage investment strategies, which will ultimately hurt investors who will have less diversified fund offerings. The Proposal will also have a chilling effect on research into short-horizon investment strategies which will harm fund investors who would have otherwise benefitted from the use of intra-day forecasts and execution techniques. Under the Proposal, investment strategies that engage in intra-day buying and selling will suddenly be suitable only for firms that are registered as broker-dealers. These types of longstanding strategies and techniques are widely used approaches that steer clear of the traditional hallmarks of dealer activity.

This outcome will have significant and deleterious effects on investors and the market. Advisers diversify their funds by pursuing a broad range of strategies; for example, a fund might make long-term investments in public companies alongside less risky investments that seek to capitalize on short-term price differences between related instruments. Or, an adviser might employ shorter duration forecasts and techniques to most economically realize its long-term view. Under the Proposal, a fund can be deemed a dealer even if the SEC-prescribed conduct is only a minor part of its diversified investment strategy. And, as a result, the adviser may well decide to forgo short-horizon strategies, leaving investors with a fund that is less diversified.

Lastly, the aggregation requirements in the Proposal mean that private fund advisers cannot use these well-established strategies within any of the funds they manage without potentially making the adviser into a broker-dealer. Because aggregation sweeps across all entities controlled by, controlling, or under common control with any person engaged in the prescribed conduct (subject to very limited exceptions), a minor part of the strategies pursued by a single fund can taint an adviser with dozens of other funds, as well as that adviser’s affiliates. With such a broad approach on aggregation, the Proposal creates major disincentives for advisers to diversify fund strategies and to try to innovate by incubating new, short-horizon investment strategies or execution techniques.
III. The SEC Has Not Adequately Justified Requiring Private Fund Advisers to Register as Broker-Dealers for Using Well-Established Strategies

The SEC justifies the Proposal’s sweeping approach by noting that some firms that are currently unregistered will otherwise continue to evade dealer registration. We note, however, that Section 20(b) of the Securities Exchange Act already sets forth a comprehensive anti-evasion provision that makes it unlawful to do indirectly what cannot be done directly. Further, to the extent that the SEC aims to require dealer registration for principal trading firms that make markets on Treasury trading platforms, the SEC can pursue more efficient, tailored rulemaking such as, for example, requiring inter-dealer Treasury trading platforms to restrict access to broker-dealers only.

Private fund advisers are registered with the SEC, subject to in-depth examinations by the SEC, and are highly regulated as fiduciaries to their clients. Requiring advisers to register as dealers will undermine their status as fiduciaries and because broker-dealer rules will be applied suddenly to the investment advisory business for the first time the Proposal will fundamentally change the private fund business.

Less than three years ago, the SEC recognized that U.S. capital markets benefit generally from having advisers that are not broker-dealers. In its “Commission Interpretation Regarding Standard of Conduct for Investment Advisers”, the SEC noted:

“Both investment advisers and broker-dealers play an important role in our capital markets and our economy more broadly. Investment advisers and broker-dealers have different types of relationships with investors, offer different services, and have different compensation models. This variety is important because it presents investors with choices regarding the types of relationships they can have, the services they can receive, and how they can pay for those services.” 84 Fed. Reg. 33669, 33669 (July 12, 2019).

But by forcing private fund advisers to become broker-dealers or otherwise abandon certain investment strategies, the Proposal will effectively subordinate investment advisers to broker-dealers. The latter will be able to trade Treasuries in larger volumes, buy and sell securities at the best prices, engage in arbitrage strategies, and deploy strategies with the full range of investment horizons. Meanwhile, advisers to private funds will be relegated to a bit role in Treasury markets and will be discouraged from pursuing anything but narrow, long-term investment strategies that are certain to avoid dealer registration. Forcing highly-regulated private fund advisers to become broker-dealers or otherwise abandon certain trading strategies and research opportunities is not a tailored or justifiable use of the SEC’s authority and would represent a grim outcome for institutional investors and U.S. markets generally.
We would welcome the opportunity to discuss this letter and engage in further dialogue with the Commission on these topics.

Respectfully submitted,

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