May 27, 2022

By Email

Vanessa A. Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 205499–1090
rule-comments@sec.gov

Re: Further Definition of "As a Part of a Regular Business" in the Definition of Dealer and Government Securities Dealer; File No. S7-12-22

Ms. Countryman:

The Securities Industry and Financial Markets Association ("SIFMA")\(^1\) appreciates the opportunity to comment on the release by the U.S. Securities and Exchange Commission (the "SEC" or "Commission") proposing new rules ("Proposing Release") to further define the phrase “as a part of a regular business” as used in the statutory 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”).\(^2\) The Commission’s proposed Rule 3a5-4 would establish certain qualitative, activity-based standards that would require market participants meeting these standards in the equity and options markets to register as dealers with the Commission.\(^3\) Similarly, proposed Rule 3a44-2 (together with proposed Rule 3a5-4, the “Proposed Rules”) would establish certain qualitative, activity-based standards, as well as certain quantitative standards, that would require market participants meeting these standards in the government securities market to register as government securities dealers with the Commission.\(^4\) The

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\(^1\) SIFMA is the leading trade association for broker-dealers, investment banks and asset managers operating in the U.S. and global capital markets. On behalf of our industry's one million employees, we advocate on legislation, regulation and business policy affecting retail and institutional investors, equity and fixed income markets and related products and services. We serve as an industry coordinating body to promote fair and orderly markets, informed regulatory compliance, and efficient market operations and resiliency. We also provide a forum for industry policy and professional development. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit http://www.sifma.org.


\(^3\) Market participants meeting the standards in proposed Rule 3a5-4 would need to register as broker-dealers under Section 15(b) of the Exchange Act.

\(^4\) Market participants meeting the standards in proposed Rule 3a44-2 not otherwise registered would need to register as government securities dealers under Section 15C(a)(2) of the Exchange Act.
Commission justifies these Proposed Rules by stating its belief that “identification and registration of these market participants as dealers, including those that are not currently regulated as dealers, would provide regulators with a more comprehensive view of the markets through regulatory oversight and would enhance market stability and investor protection.”

I. Executive Summary

While the Commission’s basis for the proposal makes sense when applied to market participants acting as proprietary/principal trading firms (“PTFs”) in the government securities market, it may inappropriately require dealer registration for non-PTF activity in the government securities market and is incomplete when applied to PTFs in the equity and options markets. As set forth in this letter, we take the following positions regarding the Proposed Rules:

- We support the policy goal of proposed Rule 3a44-2 to require PTFs in the government securities market to register as government securities dealers, but believe that the Commission can adequately capture trading activity by unregistered PTFs by adopting solely the qualitative standards set forth Rule 3a44-2(a)(1)(ii) and (iii), without the need to adopt the standard in Rule 3a44-2(a)(1)(i). Similarly, the quantitative standard in proposed Rule 3a44-2(a)(2) may be too broad and have unintended consequences in scoping in investors and other non-PTFs, and should be re-considered after a more complete evaluation of the impact of the standard on non-PTFs; and

- The Commission’s rationale to support proposed Rule 3a5-4 is incomplete because it (i) fails to adequately address why the existing regulatory structure established under the Consolidated Audit Trail (“CAT”) and Exchange Act Rule 15c3-5 (“Market Access Rule”) is insufficient to satisfy the above-mentioned regulatory goal of providing regulators with “with a more comprehensive view of the markets;” and (ii) fails to clarify and fully analyze the application of the full broker-dealer regulatory regime to equity and options PTFs required to register under Proposed Rule 3a5-4.

We also note that we are submitting a separate comment letter to address the special problems the Proposed Rules pose for bank holding companies. In addition, we note that SIFMA’s Asset Management Group is submitting a separate letter in which it expresses its view on the Proposed Rules from the buyside perspective.

Regarding the scope of proposed Rule 3a5-4, we note at the outset that we are troubled by the ambiguity regarding the potential asset classes covered by the proposed rule. Although the Proposing Release’s discussion of the proposed rule focuses almost exclusively on PTFs trading equities and listed options, it also mentions in a few places other asset classes such as corporate bonds. In this respect, as drafted, the proposed rule is very broad, and could cover all types of corporate and non-U.S. government debt securities. However, the Commission provides

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5 See Proposing Release at 23054.
6 See, e.g., Proposing Release at 23087.
no analysis of the potential impact of the proposed rule on trading in such other asset classes. For instance, the Commission does not discuss the impact of the proposed rule on corporate debt securities and other credit products such as asset-backed securities. Moreover, the Commission does not address or discuss in the proposal the definitions of “municipal securities dealer” in Section 3(a)(30) of the Exchange Act or “security-based swap dealer” in Section 3(a)(71) of the Exchange Act. Accordingly, we view such other asset classes as being outside the scope of this rulemaking and not subject to the proposed provisions, and focus our comments related to proposed Rule 3a5-4 on PTFs trading equities and listed options. We recommend that the Commission make clear that the proposed rule only applies to equities and listed options to the extent the Commission moves forward with the rule. We further note that any attempt by the Commission to apply proposed Rule 3a5-4 to trading in other asset classes is not supported by this rulemaking, as the lack of Commission analysis of the application of the proposed rule to other asset classes does not afford commenters the ability to meaningfully develop comments on this issue.

In addition to our substantive comments on the proposal, we note that the comment period provided on this proposal as well as the multiple overlapping proposals out for comment at the same time creates significant risk that meaningful public input into the rulemaking process is being lost. Sufficient time for meaningful public input into individual proposals and more holistically on the Commission’s rulemaking agenda and the possible interconnectedness of these proposals is important and ultimately could have a significant impact on savers, investors, capital formation, and economic growth and job creation.\(^7\)

II. Discussion

In justifying the need for the proposal, the Commission states its belief that, “although the Proposed Rules will not by themselves necessarily prevent future market disruptions, the operation of the rules will support transparency; market integrity and resiliency; and investor protection; across the U.S. Treasury and other securities markets by closing the regulatory gap that currently exists and ensuring consistent regulatory oversight of persons engaging in the type of activities described in the Proposed Rules.”\(^8\) As support for this position, the Commission heavily focuses throughout the Proposing Release on the extensive studies by the Inter-Agency Working Group for Treasury Market Surveillance and other groups on the market structure and regulatory gaps that currently exist in the government securities market, and the need to address those gaps by requiring significant, unregistered participants in the market to register as dealers.

As the Commission notes in the Proposing Release, electronic liquidity provision in the government securities market is a recent phenomenon that has significantly impacted the structure of the market. Among the impacts is the increased amount of liquidity provided in the market by unregistered PTFs that compete with registered dealers. We therefore support the overall policy goal in proposed Rule 3a44-2 of achieving a consistent regulatory framework for

\(^7\) See letter of 25 associations to the SEC on the importance of appropriate length comment periods, available here: (https://www.sifma.org/resources/submissions/importance-of-appropriate-length-of-comment-periods/).

\(^8\) See Proposing Release at 23060.
those entities such as PTFs that engage in similar dealing activities in the government securities market, subject to certain modifications to the rule discussed below as well as our comments related to bank holding companies.

Electronic liquidity provision in the equity and options markets is not a new phenomenon, but rather a long-standing and regulated feature of the markets. Due to the “complex, dispersed, and highly automated” nature of the equites and listed options markets, the Commission adopted Rule 613 of Regulation NMS to establish the CAT in 2012.\(^9\) Despite the vast expansion of the Commission’s ability to oversee the equity and options markets provided by CAT and the adoption of the Market Access Rule, the Commission spends very little time in the Proposing Release discussing why these enhancements to the regulatory structure are insufficient to satisfy the Commission’s regulatory goal of providing regulators with “with a more comprehensive view of the markets.” Similarly, the Commission has failed to fully consider the implications of applying the broker-dealer regulatory regime to equity and options PTFs required to register under Proposed Rule 3a5-4. SIFMA therefore believes that the Commission has provided an incomplete analysis of the policy need for equity and options PTFs to register as dealers under the proposed rule.

A. Proposed Rule 3a44-2

As a general matter, the incentives for a firm to provide liquidity in the government securities market may be impacted by the ability of market participants to compete on a relatively level playing field in which similar activities are regulated in similar fashion across the marketplace. As noted above, technology in the government securities market has changed and the diversity of market participants and complexity in trading practices and strategies has increased. Various studies have found that, among other things, trading in the Treasury market has become increasingly electronic and that unregistered PTFs now account for most of the trading in the interdealer Treasury market. SIFMA believes that the regulatory framework for government securities needs to recognize these changes and adapt and update to optimize stability and resiliency and ensure the market’s continuing viability and liquidity depth.

The SEC has proposed to expand the requirement that certain entities register as government securities dealers if they meet one of following qualitative standards: (i) routinely making roughly comparable purchases and sales of the same or substantially similar securities (or government securities) in a day; or (ii) 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; or (iii) 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. In addition to these qualitative, activity-based standards, the SEC is proposing a quantitative standard that would be applicable for government securities activities. Under this standard, a person engaged in buying and selling more than $25 billion of trading volume in government

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securities in each of four of the last six calendar months would be deemed to be doing so “as part of a regular business.”

SIFMA supports the overall policy goal in proposed Rule 3a44-2 of achieving a consistent regulatory framework for those entities that engage in similar dealing activities in the government securities market, such as PTFs. As noted above, we have long believed that given the changes in the government securities market due to technological enhancements and increasing electronification -- specifically in the market in US Treasury securities -- regulation must keep pace and recognize the diversity of new market participants that these technological changes bring. Subject to our additional comments on the application of the Proposed Rules to bank holding companies, we believe that the qualitative standards in proposed Rule 3a44-2(a)(1)(ii) and (iii) are generally a good step forward to address this long-standing asymmetric regulatory treatment for similar activities. Such an approach would enhance the long-term stability and resiliency of the government securities market by ensuring appropriate oversight of market participants based on activity being undertaken.

We believe, however, that the proposed standard in Rule 3a44-2(a)(1)(i) of “routinely making roughly comparable purchases and sales of the same or substantially similar securities (or government securities) in a day” is overly broad and ambiguous because simply buying and selling the same or substantially similar securities on the same day is not in and of itself indicative of market making or liquidity providing activity that should trigger dealer registration. Among the problems with this standard is the imprecision of the “substantially similar” concept, which would create extreme challenges for firms to establish reasonable monitoring and compliance programs to evaluate whether the government securities they traded on a particular day were substantially similar. In addition, the timeframe of a single trading day is too broad because it could capture trading activity by money managers and other market participants that is not providing liquidity to the market, but merely effecting a rebalancing of a government securities portfolio by, for example, selling short-dated Treasuries in the morning and buying longer-dated Treasuries in the afternoon. Moreover, the standard in proposed Rule 3a44-2(a)(1)(i) is unnecessary, as the standards in proposed Rule 3a44-2(a)(1)(ii) and (iii) adequately capture the trading activity by unregistered PTFs about which the Commission is concerned. We therefore recommend that the Commission drop the standard in proposed Rule 3a44-2(a)(1)(i) if it moves forward with proposed rule.

In addition, we believe that the Commission has not sufficiently considered the potential impacts of the quantitative standard in proposed Rule 3a44-2(a)(2) on non-PTFs trading government securities. The proposed standard may capture, solely due to the scale of their activities and irrespective of their activities’ purpose, certain traditional money managers and other end-users who engage in such activity on behalf of their portfolios or corporate treasury functions, respectively. In this regard, requiring entities engaged in non-dealing activity to register as dealers solely due to their size has no underlying policy rationale and could have negative impacts on investor incentives to be active in the government securities market.

Overall, we support the standards in proposed Rule 3a44-2(a)(1)(ii) and (iii) that would require unregistered PTFs in the government securities market to register as government
securities dealers. At the same time, the standard in proposed Rule 3a44-2(a)(1)(i) should be dropped and the standard in proposed Rule 3a44-2(a)(2) should be re-considered so as to not unnecessarily capture entities or activities as described above. Our concerns with the aggregation provisions in the Proposed Rules, and particularly the impact of the Proposed Rules on bank holding companies, are expressed in a separate comment letter.

B. Proposed Rule 3a5-4

As noted above, the Commission’s policy basis for issuing proposed Rule 3a5-4 is its belief that registration of equity and options PTFs will support its goal of providing regulators with a more comprehensive view of the markets, supporting the overarching goals of transparency, market integrity and resiliency, and investor protection. The Commission’s analysis of the need for such registration, however, is incomplete because it has failed to fully evaluate the adequacy of certain aspects of the existing regulatory structure governing the equity and options markets. The Commission also has failed to fully consider the application of other aspects of the broker-dealer regulatory regime to equity and options PTFs required to register under Proposed Rule 3a5-4.

1. Insufficient Consideration of CAT

Significantly, the Commission fails in the Proposing Release to sufficiently analyze why the regulatory data provided to the Commission and the self-regulatory organizations (“SROs”) by CAT is inadequate to provide the Commission with a comprehensive view of all of the equity and options trading activity in the market and the market participants behind that trading activity. In approving the CAT NMS Plan in 2016, the Commission discussed the shortcomings with the then-existing SRO audit trail data and the need for CAT, stating that “the purpose of the Plan, and the creation, implementation and maintenance of a comprehensive audit trail for the U.S. securities markets described therein, is to 'substantially enhance the ability of the SROs and the Commission to oversee today’s securities markets and fulfill their responsibilities under the federal securities laws,’” and that as contemplated by Rule 613, “the CAT ‘will allow for the prompt and accurate recording of material information about all orders in NMS securities, including the identity of customers, as these orders are generated and then routed throughout the U.S. markets until execution, cancellation, or modification.’” 10 After significant efforts by broker-dealers and the SROs since 2016, the CAT transactional database is now operational and is currently allowing the SEC and SROs to analyze comprehensive trading data from market participants, including data that was analyzed in connection with developing the Proposing Release.

While the CAT Customer ID Phase of the CAT Customer & Account Information System (“CAIS”) is not operational yet, it is scheduled to go-live on July 11, 2022. As the Commission notes in a footnote in the Proposing Release, “[r]egarding CAT data availability,

hedge funds are currently not identifiable because CAT Firm Designated ID (“FDID”) numbers do not map to broker-dealers’ customers,” but “starting in July 2022, CAT data will identify broker-dealers’ customers, including hedge funds.” Once CAT is fully operational in July, the Commission will be able to see through the CAT system the identity and equity and options trading activity of all of the active, unregistered traders the Commission is concerned about in the proposal.

The only apparent gap the Commission identifies with CAT data that dealer registration of equity and options PTFs would potentially remedy is the ability to see when a PTF initiated orders and whether it used child orders to execute a larger parent order. What the Commission fails to acknowledge in connection with this observation is that PTFs are executing orders for their own accounts, rather than for customers, and that the regulatory value of this type of data relates to the execution of customer orders (e.g., whether a broker-dealer is giving preferential treatment of its proprietary orders over customer orders). When CAT CAIS is fully operational, the Commission will be able to see every order an equity and options PTF executes in the market, which is of tremendous regulatory value to the Commission and, among other things, would allow it to monitor for potential manipulative trading across markets by PTFs.

2. Lack of Consideration of the Market Access Rule

In addition to CAT, the Commission also fails to analyze the impact of its Market Access Rule on the registration status of PTFs operating in the equity and options markets. This rule became effective after the Commission’s 2010 Equity Market Structure Concept Release, and it requires a broker-dealer with market access or that provides market access to its customers to maintain a system of risk management controls and supervisory procedures that, among other things, are reasonably designed to (1) systematically limit the financial exposure of the broker-dealer that could arise as a result of market access, and (2) ensure compliance with all regulatory requirements that are applicable in connection with market access. We understand from SIFMA member firms that one of the effects of the Market Access Rule is that many previously unregistered PTFs operating in the equity and options markets became registered as broker-dealers due to their business need to submit their orders directly into the market without having to first run them through the risk controls of other broker-dealers. Yet nowhere in the Proposing Release is this apparent market development analyzed or reviewed.

Significantly, the Commission’s analysis of the amount of volume of trading activity by PTFs in the Proposing Release appears to support this understanding that many former PTFs have already registered as broker-dealers. In support of the need for proposed Rule 3a5-4, the Commission discusses its findings based on CAT data that “institutional customer accounts” as described in the Proposing Release account for between 3.3% and 6.3% of the dollar volume of SPDR S&P 500 ETF (“SPY”) trading in October 2021. Coupled with the Commission’s ability

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11 See Proposing Release at 23082.
12 See Proposing Release at 23083.
to know the identity of these accounts when CAT CAIS goes live in July, this is a very small amount of overall trading activity by potential PTFs in the SPY market to justify the issuance of proposed Rule 3a5-4.

3. Failure to Fully Consider Implications of Applying Broker-Dealer Regulatory Regime to PTFs Required to Register

The Commission in the Proposing Release also has failed to clarify and fully analyze the application of the full broker-dealer regulatory regime to PTFs that would be required to register under proposed Rule 3a5-4. Significantly, the rule as drafted would expand the historic concept of what it means to be a liquidity provider in the equity and options markets to capture active traders who traditionally have not been considered to be dealers under the Exchange Act. Specifically, by treating persons who engage “in a routine pattern of buying and selling securities that has the effect of providing liquidity,” proposed Rule 3a5-4(a)(1) would go beyond the historic concept of market making dealer activity to capture, for example, active traders who primarily or exclusively take liquidity from the market.\(^\text{14}\) In other words, the proposal seeks to cover trading activity that historically has not been treated as market making activity, and thus would capture active traders who have traditionally been excluded from the definition of “dealer” under the Exchange Act.

This is a tremendous change from the Commission to what it means to be a dealer under the Exchange Act, and the Proposing Release does not fully address the market structure implications of such a change, such as whether active traders engaging in liquidity taking might curtail or cease their trading activity if they are required to register with the Commission as dealers.

In addition, the Commission has not clarified the application of many broker-dealer regulatory requirements, which may be triggered for PTFs required to register under proposed Rule 3a5-4. This has caused the Commission’s analysis of the application of proposed Rule 3a5-4 to PTFs to contain gaps, examples of which are described below. The Commission also has failed to discuss or analyze how this proposal may interact with other Commission proposals currently under consideration, such as its proposal to expand the scope of market participants that would be required to register as an Alternative Trading System (“ATS”), despite the Commission’s use in this proposal of concepts from that ATS proposal that have not even been adopted as final rules yet (e.g., “trading interest”).\(^\text{15}\) This lack of analysis is in stark contrast to the analysis the Commission conducted in connection with adoption the OTC Derivative Dealer Rule in Exchange Act Rule 15a-1, where the Commission conducted a thorough analysis of the

\(^{14}\) In the Proposing Release, the Commission clearly indicates that it is looking to go beyond the traditional market maker dealer concept to capture active traders who are not necessarily posting orders in the market, stating that “[t]he liquidity-providing activity captured by the Proposed Rules would include not only passive liquidity-providing activity but also aggressive trading strategies, including structural or directional trading that similarly permit a person to earn revenue from the act of buying and selling itself.” See Proposing Release at 23065-66.

need to apply certain broker-dealer requirements to OTC derivative dealers and determined in certain instances, based on the business of OTC derivative dealers, to exempt them from certain broker-dealer regulatory requirements including FINRA membership.\footnote{See Exchange Act Release No. 40594 (October 23, 1998), 63 FR 59362 (November 3, 1998).}

\begin{itemize}
  \item[a.] Failure to Consider Implications of Potential FINRA Membership

  The Commission has not addressed in the proposal whether it would ultimately require PTFs required to register under proposed Rule 3a5-4 to become members of FINRA. Section 15(b)(8) of the Exchange Act generally requires that a broker-dealer become a member of a national securities association (i.e., FINRA), unless the broker-dealer effects transactions solely on an exchange of which it is a member. Exchange Act Rule 15b9-1 currently provides a further exemption from FINRA membership, generally allowing an exchange-member dealer that carries no customer accounts and effects all of its trades with or through other registered broker-dealers to avoid FINRA membership. In 2015, however, the SEC proposed amendments to significantly narrow the Rule 15b9-1 exemption from FINRA membership.\footnote{See Exchange Act Release No. 74581 (March 25, 2015), 80 FR 18036 (April 2, 2015).}

  The lack of analysis of the potential application of FINRA rules to PTFs is a gap in the proposal. Many of the FINRA rules are designed for firms with a customer business, and thus may not apply to or be appropriately tailored for PTFs. By way of example, we note that FINRA went through a thorough rulemaking exercise to determine which one of its rules should apply to security-based swap dealers (“SBSDs”).\footnote{See Exchange Act Release No. 91789 (May 7, 2021), 86 FR 26084 (May 12, 2021).} This analysis was conducted as a result of the significant changes to the registration and regulation of SBSDs mandated by the Dodd-Frank Act. While these are FINRA rules rather than Commission ones, and the Commission has not changed the requirements of Rule 15b9-1 yet, it is not unreasonable to believe that the Commission is considering certain changes to Rule 15b9-1 based on its prior proposal. Thus, the lack of a discussion of FINRA membership by PTFs in the Proposing Release is a significant gap that makes it is very difficult for PTFs to fully understand the implications of the Proposed Rules on their activity.

  \item[b.] Failure to Consider Application of Regulation NMS

  The Commission also has failed to consider in the Proposing Release whether PTFs trading equities would need to comply with various requirements under Regulation NMS. For instance, the Commission does not address in the Proposing Release whether PTFs would be treated as “trading centers” under Rule 600(b)(95) of Regulation NMS. A “trading center” is defined under the rule to include “an alternative trading system, an exchange market maker, an OTC market maker, or any other broker or dealer that executes orders internally by trading as principal or crossing orders as agent.” Treating such firms as trading centers would subject them to a whole host of obligation under Regulation NMS, including the Order Protection Rule in Rule 611 of Regulation NMS. However, the Commission in the Proposing Release does not
address these regulations and the application to PTFs required to register under proposed Rule 3a5-4.

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SIFMA appreciates the opportunity to respond to the Proposing Release and also your consideration of our comments as set forth above. SIFMA would welcome the opportunity to meet with the Commission Staff to discuss our recommendations and any other aspects of the Proposed Rules. If you have any questions or require additional information, please do not hesitate to contact us by calling Rob Toomey at [redacted], Joe Corcoran at [redacted], or Ellen Greene at [redacted].

Sincerely,

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Equities & Options Market Structure

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