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

Submitted electronically via rule-comments@sec.gov

May 27, 2022

Dear Ms. Countryman:

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

The Alternative Investment Management Association (AIMA)[1] appreciates the opportunity to comment on the U.S. Securities and Exchange Commission's (SEC or Commission) proposed rule to further define the phrase "as 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 (the "Exchange Act")(the "Proposal").[2] AIMA's members include institutional investment managers, many of whom may be implicated by the Proposal and forced to register as a dealer or a government securities dealer, either at the level of the private fund adviser or at the level of the private fund itself, even though they do not engage in dealing activities.

[1] AIMA, the Alternative Investment Management Association, is the global representative of the alternative investment industry, with around 2,100 corporate members in over 60 countries. AIMA's fund manager members collectively manage more than $2.5 trillion in hedge fund and private credit assets. AIMA draws upon the expertise and diversity of its membership to provide leadership in industry initiatives such as advocacy, policy and regulatory engagement, educational programs and sound practice guides. AIMA works to raise media and public awareness of the value of the industry. AIMA set up the Alternative Credit Council (ACC) to help firms focused in the private credit and direct lending space. The ACC currently represents over 250 members that manage $600 billion of private credit assets globally. AIMA is committed to developing skills and education standards and is a co-founder of the Chartered Alternative Investment Analyst designation (CAIA) – the first and only specialized educational standard for alternative investment specialists. AIMA is governed by its Council (Board of Directors). For further information, please visit AIMA's website, www.aima.org.

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

If the Proposal is adopted as is, it could significantly impact the trading and investing strategies, operations, risk management, compliance and reporting functions of AIMA members, including both the advisers and the private funds they manage. The Proposal could also profoundly affect liquidity, competition and efficiency in both U.S. securities and government securities markets. Despite the Proposal's substantial intended and unintended consequences, which we discuss below, the Commission provided for a very brief comment period, a mere 60 days from the Proposal's release, for interested parties to submit their responses. AIMA filed a request for an extension to the comment period to allow market participants, market infrastructure providers and other affected and interested parties the necessary time to review, analyze and submit thoughtful and comprehensive comments to the Commission.[3]

The Commission did not grant our request nor those submitted by other associations. We believe, the excessively short comment period will detract from the quality of the rulemaking process and leave the Commission without extensive feedback from industry participants who are directly affected by the Proposal, as well as those that may experience secondary effects from requiring the registration of a substantial number of additional dealers and government securities dealers, including the contraction of liquidity, competition and efficiency in U.S. capital markets that will inevitably result from at least some market participants withdrawing from affected markets or reducing the level of their activity.

The Proposal would amend the definitions of dealer and government securities dealer to further define these terms to identify certain activities that would constitute "regular business" thereby requiring a person engaged in those activities to register as a dealer or government securities dealer.[4] The Proposal focuses on market participants who engage in a routine pattern of buying and selling securities for their own account that has the "effect of providing liquidity."[5]

We believe the Proposal will have extensive adverse effects for U.S. capital markets, AIMA members, other market participants and market infrastructure providers. Our private fund adviser members and the funds they manage trade *with* dealers; they are *not* dealers and should not be considered as such. These private fund advisers are already subject to extensive regulation under the Advisers Act and report on their trading activities via Form PF. They should not now become beholden to an additional, redundant regulatory regime that will yield few, if any, benefits to the Commission, markets or other market participants. Therefore, prior to consideration of a final rule, we believe the Commission should:

- Exclude registered private fund advisers and the private funds they manage from the scope of the Proposal. Failing that, it should;

- Withdraw the proposed quantitative standard because there is no statutory basis for determining by sheer volume of transactions whether a person is a government securities dealer, and, as

[3] AIMA Letter, "Request for extension of comment period for File No. S7-12-22" *available at*, https://www.sec.gov/comments/s7-12-22/s71222-20128259-290066.pdf.

[4] Proposing Release, *supra* note 2, at 23061.

[5] *Id.* at 23062.

drafted, the standard would capture activity in government securities markets beyond what may be deemed as supplying liquidity;

- Reassess the proposed qualitative standards to remove any ambiguity so that market participants will have the necessary certainty to engage in their trading and risk management strategies without becoming subject to an unnecessary requirement to register as a dealer or government securities dealer; and

- Eliminate the requirement that persons aggregate all accounts under their control, even if their trading decisions are completely independent of each other.

These points are discussed in further detail below in the attached annex with relevant data points provided. We would be happy to elaborate further on any of the points raised in this letter. For further information, please contact Daniel Austin, Director of U.S. Policy and Regulation, by email at daustin@aima.org.

Yours sincerely,

Jiří Król
Deputy CEO, Global Head of Government Affairs
AIMA

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

ANNEX

1. **We believe that the Proposal's monetary and non-monetary costs are not adequately identified and considered in the Proposing Release, and they far outweigh any perceived benefits that may accrue to the Commission, market participants or the markets.**

The Commission is proposing to amend the definitions of "dealer" and "government securities dealer" to further define these terms to identify certain activities that would constitute "regular business" thereby requiring a person engaged in those activities to register as a dealer or government securities dealer.[6] The Proposal focuses on market participants who engage in a routine pattern of buying and selling securities for their "own account that has the effect of providing liquidity."[7]

The Proposal would set forth three qualitative standards designed to identify market participants who assume, what the Commission believes to be, certain dealer-like roles, particularly those whose actions have the effect of providing liquidity,[8] yet every purchase of a security presumably provides liquidity. There is also no presumption that a person is not a dealer or government securities dealer solely because that person does not engage in the qualitative standards, such that other patterns of buying and selling may have the effect of providing liquidity to other market participants or otherwise require a person to register according to the Proposal.[9]

Specifically, Proposed Rules 3a5-4 and 3a44-2 would require a person to register as a dealer or government securities dealer, respectively, if it: (i) routinely makes roughly comparable purchases and sales of the same or substantially similar securities (or government securities) in a day; (ii) routinely expresses 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) earns 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.[10]

Proposed Rule 3a44-2 would also establish a quantitative standard under which a person engaging in certain specified levels of activity would be deemed to be buying and selling government securities "as part of a regular business," regardless of whether that person meets any of the Proposal's qualitative standards.[11] A person engaged in buying and selling government securities for its own account is engaged in such activity "as part of a regular business" if that person in each of four out of the last six calendar months, engaged in buying and selling more than $25 billion of trading volume in government securities.[12]

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6 *Id.* at 23061.
7 *Id.*
8 *Id.* at 23061-62.
9 *Id.* at 23065.
10 *Id.* at 23066-67, 69.
11 *Id.* at 23071
12 *Id.*

The Commission intends for the Proposal to "close the regulatory gap" by "ensuring consistent regulatory oversight"[13] and believes, among other things, it will "support orderly markets and protect investors"[14] and "promote the financial and operational resilience of individual liquidity providers in securities markets and would improve the Commission's ability to monitor market activity, conduct research and detect manipulation and fraud."[15] We respectfully disagree and believe that the Proposal, if finalized in its current form, will have profound and negative impacts on liquidity, competition and efficiency in both the securities and government securities markets.

The Commission's Economic Analysis highlights multiple, significant monetary costs and other negative effects that may result from the Proposal, while citing few benefits it believes may accrue from additional market participants being subject to the dealer regulatory framework. The Commission explains that market participants would face the costs of: (i) registering with the Commission and with an SRO; (ii) recordkeeping and reporting costs; (iii) meeting capital requirements; and (iv) continuous self-evaluation as to whether one is a dealer.[16] Market participants required to register and that trade NMS stocks, OTC equities or listed options would also incur the costs of reporting their transactions in these securities to the Consolidated Audit Trail (CAT).[17]

The Commission estimates that registering with it and becoming a member of an SRO will cost $600,000 initially and $265,000 annually thereafter.[18] These costs are based on similar estimates in the adopting release for Regulation Crowdfunding and adjusted for inflation between October 2015 and September 2021.[19] Despite this adjustment, we believe the Commission's estimates are well below the actual out-of-pocket costs market participants would face if forced to register as a dealer. The Commission fails to cite here[20] or in Regulation Crowdfunding[21] any specifics as to how it estimates these initial and ongoing costs. The Proposal simply notes that these costs "may vary significantly across registrants, depending on facts and circumstances."[22] It is also worth noting that, since September 2021, inflation has gradually increased, leading to even higher costs for market participants.[23]

The Commission further estimates the per-firm costs of CAT reporting to be $965,000 to $8,218,000 for one-time implementation, plus ongoing costs of $503,000 to $5,405,000 annually.[24] In other

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13 *Id.* at 23072.
14 *Id.* at 23078.
15 *Id.*
16 *Id.* at 23089.
17 *Id.* at 23090.
18 *Id.* at 23089.
19 *Id.* at n. 268.
20 *Id.* at 23089.
21 SEC, Adopting Release, Regulation Crowdfunding, [80 Fed. Reg. 71388, 71509](#) (Nov. 16, 2015).
22 Proposing Release, *supra* note 2, at 23089, n. 268.
23 *See* News Release, Bureau of Labor Statistics, Consumer Price Index – April 2022 (May 11, 2022), https://www.bls.gov/news.release/cpi.nr0.htm.
24 Proposing Release, *supra* note 2, at 23090.

words, the Commission's estimated costs for complying with just a ***single*** dealer requirement (CAT reporting) far exceed the estimated total costs associated with dealer registration. Furthermore, market participants would need to create separate reporting infrastructures for other asset classes, including corporate bonds and U.S. Treasuries, as well as implementing entirely new regulatory reporting, monitoring, and surveillance systems, leading to additional costs. Market participants would also face even further costs becoming a member of the Securities Investor Protection Corporation and the Financial Industry Regulatory Authority (FINRA) and complying with the entire FINRA rulebook.

Taken together, market participants required to register as a dealer or government securities dealer will face tremendous monetary costs. As the Commission notes, market participants will also face monitoring costs to comply with the capital requirements and may be forced to increase their capitalization either by raising equity or scaling back trading activities.[25] Market participants that may not initially register would incur the costs of continuous self-evaluation regarding whether the qualitative standards describe their activities.[26]

The Commission acknowledges that these substantial costs may also affect market efficiency, competition and capital formation.[27] It further acknowledges that the Proposal's net effect on each of these aspects is "***uncertain***."[28] We respectfully question how the Commission can justify a rulemaking of this magnitude, which will lead to significant direct and indirect costs for market participants, without any reasonable qualitative or quantitative estimate as to its effects on efficiency, competition and capital formation in the securities or government securities markets. All of these must be recognized as very significant costs, but they are essentially ignored in the Proposal. We believe that the net effect will be severe harm to market efficiency, competition and capital formation.

To avoid the substantial initial and ongoing costs of becoming a dealer or a government securities dealer, some market participants will inevitably change or abandon certain investment or trading strategies. This will necessarily harm price discovery, impair market liquidity and exacerbate volatility in either, or both, the securities or government securities markets, with spillover effects to futures and OTC derivatives markets, among others. Market competition may suffer as firms change their trading behavior, leading to, perhaps, a concentration of risk in fewer firms.

The Proposal will clearly have considerable, direct and indirect costs for market participants, and, although the Commission believes the net effect of these costs on market dynamics to be "uncertain," we believe market efficiency, competition and capital information will all be negatively impacted. Under the Administrative Procedure Act, as interpreted, the Commission has an obligation to make a

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25 *Id.*

26 *Id.*

27 *Id.* at 23091-92.

28 Emphasis added. "The net effect on market efficiency is uncertain." *Id.* at 23091. "The net effect that the Proposed Rules may have on competition is uncertain." *Id.* "The likely effect on aggregate market participation is uncertain." *Id.* at 23092.

reasonable estimate of these costs, yet none appears in the Proposal. We respectfully question whether the Commission has fully assessed the effects the Proposal will have on market participants, market infrastructure providers and securities and government securities markets.

2. The Commission should exclude registered private fund advisers and the private funds they manage from the scope of the Proposal.

The Commission believes that Proposed Rule 3a5-4 and Proposed Rule 3a44-2 would primarily require registration by principal trading firms (PTFs) and potentially private funds, including hedge funds.[29] It also explains that the activities of some registered investment advisers (RIAs) – either through their own proprietary trading or through the aggregation of the activities of the accounts under their control – could also be within scope and therefore trigger registration as a dealer or government securities dealer.[30] The Proposal would not apply to a person that has or controls total assets of less than $50 million or an investment company registered under the Investment Company Act of 1940.[31]

Private funds are not exempt from the Proposal despite the Commission's acknowledgement that registered private fund advisers are subject to extensive requirements under the Advisers Act and that information on private fund activities are reported by private fund advisers on Form PF.[32] To justify this determination, the Commission explains that the information it receives on private funds differs from the information it collects for the purposes of dealer registration.[33] Similarly, the Commission has not excluded RIAs from the scope of the Proposal.[34]

Among private funds, the Commission believes hedge funds are the most likely to be engaged in activities that meet the Proposal's qualitative standards or quantitative standard; however, the Commission acknowledges that the "extent to which hedge funds may satisfy these standards is uncertain."[35] As the Proposal explains, registered private fund advisers are currently subject to an extensive regulatory framework under the Advisers Act.[36] Indeed, the Commission's view expressed in the Proposal is that the only differences between the regulatory regime for private fund advisers and securities dealers are leverage constraints and reporting,[37] yet the Commission has chosen to include both private funds and their advisers within the scope of the Proposal. We disagree with this

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29 *Id.* at 23057.

30 *Id.* at 23078.

31 *Id.* at 23062. In proposing to exclude registered investment companies (RICs), the Proposal explains that, because of the regulatory framework under which RICs operate, the Commission already has extensive oversight and broad insight into their operations and activities. *Id.* at 23063. The Commission concludes that the RIC regulatory framework already addresses the types of concerns the Proposal seeks to address. *Id.*

32 *Id.* at 23063-64.

33 *Id.* at 23064.

34 *Id.* at 23079.

35 *Id.* at 23082.

36 *Id.* at 23083.

37 *Id.* The Commission's characterization, however, is not entirely accurate, as there are differences between SEC regulations and FINRA rules. For example, FINRA imposes some constraints on marketing (the use of hypothetical performance, pre-approval of marketing materials, etc.) that the SEC's marketing rule does not.

determination and, accordingly, we would encourage the Commission to exclude registered private fund advisers and the private funds they manage from any final rule.[38]

Under the Advisers Act, registered private fund advisers are subject to: (i) antifraud measures; (ii) reporting and recordkeeping requirements for investor protection and systemic risk purposes; (iii) certain books and records requirements; (iv) fiduciary duties (both the duty of care and duty of loyalty); (v) annual and quarterly reports to the Commission; and (vi) Commission examinations.[39]

We believe this regulatory regime is entirely sufficient for private fund advisers and the funds they manage, especially when the Commission believes that there are only two differences between the private funds and dealer regulatory frameworks.[40] To the extent the Commission disagrees, it can propose amendments to regulations under the Advisers Act, as it has recently done.[41] We agree with the Commission when it concludes that in registering private funds as dealers "the marginal benefits of other reporting requirements, net capital requirements, books and records rules, and examinations *might be very small*."[42] Furthermore, all transactions by private funds are already reported, both to regulators and the public, as they transact with Commission-registered dealers, so one of the main purported benefits identified in the Proposal is illusory. It therefore appears clear that the costs of the Proposal, vis-à-vis private fund advisers and private funds, outweigh the perceived benefits that may accrue to the Commission, market participants and the markets, even before considering the very substantial societal costs that result from the Proposal.

The Commission does seem to believe that there would be some benefit from private fund advisers reporting their transactions.[43] As the Commission notes, hedge funds do not report their transactions, so they are not currently identifiable in CAT data or in TRACE data, beyond a subset of U.S. Treasury data. However, their transactions are reported by their broker-dealer agents and counterparties, and, starting in July 2022, CAT data will identify broker-dealers' customers, including hedge funds.[44] Accordingly, we believe it would be entirely redundant, unnecessary and costly to require a private fund adviser to report its transactions to CAT when the broker-dealer it trades with will be reporting that information well before the effective date of any rules adopted pursuant to the Proposal.

The Commission has also failed to provide any explanation or guidance as to how the dealer regulatory framework would apply to private fund advisers and private funds.[45] It seems to assume

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38 As the Commission notes, hedge funds are the most likely to be engaged in the activities that satisfy the proposed rules. Proposing Release, *supra* note 2, at 23082.

39 *Id.* at 23083.

40 The two differences pertain to leverage constraints and reporting. *Id.* at 23083.

41 SEC, Proposing Release, Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews, [87 Fed. Reg. 16886] (Mar. 24, 2022).

42 Proposing Release, *supra* note 2, at 23088. Emphasis added.

43 *Id.*

44 *See id.* at 23082, n. 228.

45 Nor does the Proposal consider the change in status and relationships private funds and their advisers would undergo vis-à-vis their existing counterparties.

that existing private fund advisers' and private funds' organizational and operational structures will fit neatly within the dealer regulatory regime when this is simply not the case. The Commission ignores the blurring-of-the-lines as to the actual roles each (advisers and private funds) play in the market and the resulting conflict that may result in constitutional documents that do not support, endorse or look to provide a framework for a dealer function.

First, typical memoranda and articles of association (or other equivalent constitutional rulebook) of a private fund or private fund adviser do not reflect any binding understanding between the business and its owners to embark upon or maintain the operation of a dealer. While owners do empower management to comply with the necessary laws and regulations, the effort and cost of doing so vis-à-vis the Proposal will be expended on complying with a business model to which the owners have not subscribed. The resulting work, capital outlays, registration costs and distraction may destabilize investment and capital flow in private fund and private fund adviser businesses.

Second, notwithstanding the above, take the application of the Net Capital Rule[46] as an example. The Net Capital Rule requires a broker-dealer to always have and maintain net capital at specific levels to protect customers and creditors from monetary losses in the event the broker-dealer fails.[47] Investors contribute capital to subscribe for shares or limited partner interests in a private fund, and the capital becomes an asset of the fund on its balance sheet. At their core, these are investors, not customers or creditors, the two parties the Net Capital Rule is designed and intended to protect.

Assume Hedge Fund A meets one of the proposed qualitative standards, and Hedge Fund A is managed by Registered Adviser B. Pursuant to the Proposal, Hedge Fund A must register as a dealer and therefore be subject to the entire dealer regulatory regime, including the Net Capital Rule. It remains unclear whether or how the Net Capital Rule would apply to Hedge Fund A. One could assume Hedge Fund A would be required to set aside a percentage of its assets/capital, yet the Commission has not offered any guidance regarding its application at the fund level.

Let us assume Registered Adviser B exercises more than investment discretion over Hedge Fund C and Hedge Fund D and must therefore aggregate both funds' activities under the Proposal. Combined, the two hedge funds meet one of the proposed qualitative standards, and Registered Adviser B must register as a dealer. Would Registered Adviser B then be required to comply with the Net Capital Rule? Would the capital requirement apply to both Hedge Fund C and Hedge Fund D? Would it be bifurcated based on trading activity or otherwise? We respectfully question how Registered Adviser B could comply with the Net Capital Rule and whether the Commission has considered whether such an outcome is possible, let alone practicable.

Third, assuming the dealer regulatory framework could be layered on top of existing adviser regulations, a dually registered entity, i.e., both a private fund adviser and a dealer, would encounter

[46] 17 CFR 240.15c3-1 (the "Net Capital Rule").

[47] *See id.*

informational and trading challenges. For example, the same set of traders managing the private fund would also be trading through the dealer. This scenario would present the challenge, if not the impossibility, of creating an informational barrier between the two sides (adviser and dealer), as required by law. Private funds would also lose customer status under Commission regulations and lose access to the U.S. IPO market because registered broker-dealers are considered "restricted persons" under FINRA rules.

Fourth, the Proposal would place tremendous pressure on resources, particularly where the lack of available skilled financial executives is already an issue and labor costs are dynamic. Private funds and private fund advisers required to register under the Proposal would also likely face significant changes in audit rules and procedures to comply with the dealer standard, leading to a change in the incumbent audit team. The Commission ignores the fact that most private funds have little, if any, of their own administrative personnel and will be forced to delegate these new burdensome requirements. Currently, there is the open question whether a sudden spike in demand, which may be brought on by a final rule akin to the Proposal, can be met for highly skilled and knowledgeable executives necessary to undertake dealer registration and the ongoing tasks and whether these executives can be hired on reasonable terms. Furthermore, it appears the Commission failed to consider whether there is any capacity in the relevant, competent auditor pool to meet new and compulsory business needs.[48]

The Commission appears concerned that if it did exempt private funds and registered private fund advisers from the scope of the Proposal, PTFs may restructure as private funds and register as advisers to avoid registration as a dealer or government securities dealer. The Proposal, however, lacks any evidence that PTFs will engage in such behavior. Instead, the Commission is operating simply upon the assumption that a PTF might register as an adviser.

In making this determination, the Commission seems to believe that restructuring into a private fund and registering as an adviser is a simple, inexpensive task and that PTFs will use this alternative to avoid registration as a dealer or government securities dealer. Such a task is neither simple nor inexpensive, and, if an entity, in good faith, seeks to restructure and register as an adviser, it is within its rights to do so. Even if a PTF registers as an adviser, we question whether this would be a negative outcome, especially since the Commission believes there are only two differences between the private fund/adviser and dealer regulatory frameworks. To the extent PTFs do register as advisers, the SEC would then have the same authority over them, and the same information from them, that the SEC now has from other registered advisers; the SEC would have accomplished the goals identified in the Proposal.

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[48] Notably, the SEC and FINRA recently relaxed timing requirements of broker-dealer audits because of a lack of third-party audit firms.

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To summarize, we would encourage the Commission to exclude registered private fund advisers and private funds from the scope of the Proposal because their inclusion is entirely unnecessary and redundant. It would layer an additional and unworkable regulatory regime, with tremendous direct and indirect costs, on private fund advisers and private funds without yielding any material benefits. Furthermore, the Commission does not seem to appreciate that these direct and indirect costs would limit market liquidity, lead to increased volatility and harm price discovery in both the securities and government securities markets, with spillover effects to the futures and OTC derivatives markets, among others.

3. **The Commission should withdraw the proposed quantitative standard because there is no statutory basis for determining by sheer volume of transactions whether a person is a government securities dealer, and, as drafted, the standard would capture activity in government securities markets beyond what may be deemed as supplying liquidity.**

Proposed Rule 3a44-2 would also establish a quantitative standard under which a person engaging in certain specified levels of activity would be deemed to be buying and selling government securities "as part of a regular business," regardless of whether that person meets any of the Proposal's qualitative standards.[49] A person engaged in buying and selling government securities for its own account is engaged in such activity "as part of a regular business" if that person in each of four out of the last six calendar months, engaged in buying and selling more than $25 billion of trading volume in government securities.[50]

At the outset, we note that there is no statutory support, nor support in case law construing the Exchange Act definitions of dealer and government securities dealer, for a quantitative standard. Indeed, as the Commission explains, there are certain factors associated with dealing activity: (i) acting as a market maker or specialist; (ii) acting as a *de facto* market maker or liquidity provider; and (iii) holding oneself out as buying or selling securities at a regular place of business.[51] A quantitative standard does not recognize the fundamental difference between a customer and a dealer in the market. Moreover, a quantitative standard cannot legitimately be used as a proxy for dealer activity because it may well compound market illiquidity, a result in direct opposition to what a dealer function ought to imply. Therefore, for this reason and those below, we would encourage the Commission to eliminate the quantitative standard.

According to data analyzed in the Proposal, the Commission estimates that approximately 46 non-FINRA member firms surpassed the $25 billion volume threshold in July 2021, 22 of which are classified as PTFs and 20 are dealers, leaving four remaining firms.[52] Of these four remaining firms, the Commission estimates that at least one hedge fund surpassed the quantitative standard; however, it

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49 Proposing Release, *supra* note 2, at 23071
50 *Id*.
51 *Id.* at 23058-59.
52 *Id.* at 23081.

acknowledges that other hedge funds may meet the quantitative standard.[53] These 46 non-FINRA members would be required to register as government securities dealers pursuant to Proposed Rule 3a44-2's quantitative standard; however, the Commission recognizes that some of the 20 firms acting as dealers may be exempted from registration or affiliated with other entities that are registered dealers, in which case the parent entity could avoid the costs of registration by shifting the activities covered by the quantitative standard to the registered dealer affiliate.[54]

The Commission's estimated number of impacted firms is incorrect because it only examined data where counterparty identities are included (42% of the total trading volume executed by non-FINRA members). These transactions are executed on registered alternative trading systems ("ATSs"), where counterparty identities are required to be disclosed by regulation. However, for purposes of setting the quantitative standard and estimating the number of firms captured by it, the Commission assumes that "all non-FINRA member market participants are equally represented in both the anonymous and identified subsets of TRACE,"[55] which would mean that the 42% of data provides the Commission with a view into the trading activity of all non-FINRA member firms. Operating on this assumption is wrong and misguided.

Registered ATSs generally cater to the dealer-to-dealer segment of the U.S. Treasury market, where PTFs are active participants. However, customers generally transact in the dealer-to-customer segment of the U.S. Treasury market either bilaterally or on trading venues that are not registered as ATSs. This means that the data analyzed by the Commission provides little to no view into the Treasury trading activity of customers. As a result, the Commission is unable to appropriately calibrate a quantitative threshold or accurately estimate the number of customers that would be captured.

Our anecdotal analysis and conversations with market participants indicate that the quantitative standard would capture substantially more firms than the Commission preliminarily estimates. In fact, we currently believe the number of just hedge funds required to register as government securities dealers – by virtue of the quantitative standard alone – would be closer to 50 because of the number of strategies that may satisfy such standard. For example, the often-used Treasury basis trade, which generally involves longer holding periods, could lead to some private funds meeting the quantitative standard despite the fact that this strategy does not resemble any of the proposed qualitative standards that purport to demonstrate dealing activity.

Also, consider a strategy that focuses on relative value trading in the U.S. Treasury complex (bonds and associated futures). The average holding period for some of these strategies may be around two weeks, with annual turnover being a significant multiple of a firm's gross balance sheet. Relative value strategies are not, and nor should they be, considered dealing activity. We would also note that Form

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53 *Id.* at 23081.
54 *Id.* at 23100, n. 306.
55 *Id.* at 23081.

PF includes monthly trading volumes by market value, so we question why the SEC has not utilized this data to estimate how many funds may be captured under the quantitative standard.

Furthermore, the number of total market participants subject to registration under the quantitative standard is likely to be higher than our estimates because the Commission has not limited the scope of the Proposal,[56] capturing market participants beyond those the Commission considers. For example, during times of market stress or volatility, investors may flock to the Treasury markets in search of acquiring less-risky assets or selling Treasury securities in a dash for cash. Of course, these actors are not just limited to those the Commission considers in the Proposal. Entities like sovereign wealth funds, pensions, insurers, large corporations and more may indeed trigger the $25 billion threshold, yet the Commission does not fully assess the effect a quantitative standard will have on market participants like these and others that are not clearly intended to be captured by the Proposal's broad applicability.

It is likely that a substantial number of firms impacting by the quantitative standard will significantly curtail their trading activity in Treasury securities so as to remain below the threshold for registration. This would limit liquidity and competition in the cash Treasury market and have spillover effects to the futures and OTC derivatives markets, among others. Despite the Commission's belief that the net or aggregate effect of the Proposal is "uncertain,"[57] we believe these negative consequences will materialize, a result neither the Commission, nor other federal financial regulators, should welcome. Therefore, we reiterate our request that the Commission withdraw any quantitative standard from a final rule.

4. **The Commission should reassess the proposed qualitative standards to remove any ambiguity so that market participants will have the necessary certainty to engage in their trading and risk management strategies without becoming subject to an unnecessary requirement to register as a dealer or government securities dealer.**

Proposed Rules 3a5-4 and 3a44-2 would set forth three qualitative standards designed to identify market participants who assume certain dealer-like roles, particularly those who as act as liquidity providers.[58] There is also no presumption that a person is not a dealer or government securities dealer solely because that person does not engage in the qualitative standards, such that other patterns of buying and selling may have the effect of providing liquidity to other market participants or otherwise require a person to register pursuant to the Proposal.[59]

It is quite odd that the Commission seems to want to discourage liquidity, even though it has not considered this practical effect of the Proposal. In declining markets, for example, hedge funds may

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56 The Proposal would not apply to a person that has or controls total assets of less than $50 million or a RIC.

57 *See supra,* footnote 28 and accompanying text.

58 Proposing Release, *supra* note 2, at 23061-62.

59 *Id.* at 23065.

enter the markets with the intent of providing liquidity to other investors that may need to sell. This reflects the different investment time horizons and risk appetites of the buyer and seller, but this is not close to, nor resemble, market making and continuously quoting two-way prices to all market participants.

Specifically, Proposed Rules 3a5-4 and 3a44-2 would require a person to register as a dealer or government securities dealer, respectively, if it:

(i) routinely makes roughly comparable purchases and sales of the same or substantially similar securities (or government securities) in a day ("Qualitative Standard 1");
(ii) routinely expresses 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 (Qualitative Standard 2"); or
(iii) earns 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 ("Qualitative Standard 3").[60]

The proposed qualitative standards are incredibly broad, unclear and would capture a significant amount of investing and trading that is inconsistent with any reasonable notion of dealing. This would chill trading and investing activity and strategies of all kinds, discourage risk management and, in turn, harm liquidity, market competition and market efficiency. We believe the Commission should revise its qualitative standards because, as drafted, they would implicate a substantial number of market participants, far beyond the 51 the Commission estimates, many of whom should not be subject to an unnecessary requirement to register as a dealer or government securities dealer.[61]

Qualitative Standard 1

The test for Qualitative Standard 1 includes four parts: (i) routinely; (ii) makes roughly comparable purchases and sales; (iii) of the same or substantially similar securities; and (iv) in a day.[62] The Commission would define "routinely" to mean more frequent than occasional but not necessarily continuous, but intraday and across time, meaning both repeatedly within a day and on a regular basis over time.[63] "Roughly comparable" would mean purchases and sales similar in dollar volume, number or risk profile to maintain a near market-neutral position.[64] The "same" securities would mean securities bought and sold of the same class and having the same terms, conditions and rights, and "substantially similar" would be based on a facts and circumstances analysis.[65] Finally, the

60 *Id.* at 23066-67, 69.
61 *Id.* at 23099.
62 *Id.* at 23066.
63 *Id.* at 23066, 23068.
64 *Id.* at 23066.
65 *Id.* at 23067.

Commission believes "in a day" would be a sufficient duration to capture the trading activity typical of dealer liquidity providers.[66]

On its surface, Qualitative Standard 1 seems clear; however, when it is examined further, the opaqueness increases. The Commission provides several illustrations of what it deems to be purchases and sales of "substantially similar" securities: buying stock and selling bonds issued by the same company or buying cash Treasury securities and selling Treasury futures.[67] According to the Commission, if a market participant routinely engages in this kind of buying and selling of securities or government securities during a day, it may be deemed to have the effect of providing liquidity, and the participant would be required to register as a dealer or government securities dealer.

We believe Qualitative Standard 1 would capture a significant number of investing and trading strategies that go beyond traditional dealing activity, and, as a result, the Commission's estimation that approximately 51 market participants would be required to register is unrealistically low. Many hedge fund strategies, e.g., fixed-income arbitrage, convertible bond arbitrage, capital structure arbitrage, as well as a number of relative value or quantitative strategies, could be captured by Qualitative Standard 1. These strategies are long-standing alternative investment strategies that have never been thought of as providing dealing or market-making services. These strategies may have the effect of providing liquidity, which is an enormous benefit to U.S. capital markets, but they are not and should not be equated to dealing.

Take, for example, a global macro fund that uses a simple and common options strategy whereby it may simultaneously buy and sell options on the same underlying asset at different strike prices. These funds may meet Qualitative Standard 1 and be required to register. At its most basic level, it appears Qualitative Standard 1 could capture simple hedging if it is done routinely and in coordination with buying or selling activity. Furthermore, simply trading securities or government securities that has the "effect of providing liquidity" could trigger registration, leading to an after-the-fact assessment by the Commission whether a market participant's trading activity has provided liquidity.

Qualitative Standard 2

Qualitative Standard 2 also includes four parts: (i) routinely; (ii) expressing trading interests; (iii) at or near the best available prices on both sides of the market; and (iv) communicated and presented in a way that makes them accessible to other market participants.[68] "Routinely" would have the same meaning as under Qualitative Standard 1.[69] The Commission would define "trading interest" to mean an order or any non-firm indication of a willingness to buy or sell a security that at least identifies the security and either the quantity, direction (buy or sell), or price.[70] The Commission believes "at or near

66 *Id.*
67 *Id.*
68 *Id.* at 23068.
69 *Id.*
70 *Id.*

the best available prices on both sides of the market" describes the activity of liquidity-providing dealers that help determine the spread between the best available bid price and the best available ask price for a given security.[71] Finally, "communicated and presented in a way that makes them accessible to other market participants" would mean that a market participant routinely makes its trading interests available to other market participants.[72]

Like Qualitative Standard 1, it does not appear that the Commission considered the practical effect of Qualitative Standard 2 and how many market participants would be required to register. Some asset managers may have funds with, for example, active fixed-income trading strategies. The fund traders will often indicate interest to trade bonds, as well as swaps, on similar or even identical underlying issuers in order to take advantage of mispricing or to create a unique non-directional risk profile in a trade. In dealer markets, this will entail communicating and indicating interest on such trades to a number of counterparties. Again, to date, such behavior has never been considered dealing.

Yet again, because an actively traded fund engages in an activity that may have the effect of providing liquidity and engages simultaneously on the long and the short side does not and should not equate to dealing. In another example, as currently drafted Qualitative Standard 2 would appear to prohibit a customer from routinely using a central limit order book (CLOB) trading protocol in any securities market regulated by the Commission because a CLOB enables customers to post both resting orders and trade against available liquidity.

Qualitative Standard 2 would lead to market participants with active trading strategies to curtail their trading. This would result in less liquidity, harm market efficiency and limit market competition. Also, as these active funds limit their trading, the funds' overall returns may suffer, thereby harming the underlying investors in those funds. The Commission estimates that 51 market participants will be required to register based on all three qualitative standards. Again, we believe the Commission's estimate is significantly below the total number of market participants that would be implicated under the qualitative standards.[73]

Qualitative Standard 3

Qualitative Standard 3 would require a person to register as a dealer or government securities dealer if that person earns revenue primarily from capturing bid-ask spreads or from capturing any incentives offered by trading venues to liquidity-supply trading interests.[74] Therefore, if a person derives a majority of its revenue from capturing bid-ask spreads or liquidity incentives, or a

71 *Id.*
72 *Id.*
73 *Id.* at 23099.
74 *Id.* at 23069.

combination of the two, it would be deemed a liquidity provider for the purposes of the Proposal and be required to register as a dealer or government securities dealer.[75]

We believe the Commission should limit its qualitative standards to only Qualitative Standard 3. Capturing bid-ask spreads or earning revenue from liquidity incentives have traditionally been indicative of dealing activity and further defining the definitions of "dealer" and "government securities dealer" to include these two attributes would be a practical solution. Although some market participants may be required to register pursuant to Qualitative Standard 3, the number would be significantly less than under Qualitative Standards 1 and 2, either combined or on their own. Qualitative Standard 3 would be less likely to capture the funds, advisers and strategies that would be unnecessarily implicated by Qualitative Standards 1 and 2, and the secondary effects on liquidity, competition and efficiency would be lessened if only Qualitative Standard 3 were included in a final rule.

To conclude, we believe that, because the of scope of Qualitative Standards 1 and 2 is excessively broad and will capture a significant number of investing strategies and activity that are not dealing, the Commission's estimate that about 51 market participants will be required to register as a dealer or government securities dealer is unrealistically low. In fact, given the number of active trading and investing strategies, we currently hundreds of entities, if not more, will be required to register. This result would have a significant, and likely drastic, effect on market liquidity, competition and efficiency as market participants limit these strategies to avoid registration. The impact on securities and government securities markets would likely be substantial, but such impact would not be limited to just these markets, as futures and OTC derivatives markets would also be affected. Accordingly, we believe the Commission should exclude Qualitative Standards 1 and 2 from any final rule.

5. **The Commission should eliminate the requirement that persons aggregate all accounts under their control, even if their trading decisions are completely independent of each other.**

Pursuant to the Proposal, persons[76] would need to aggregate the activities of their "own account[s]" to determine whether either the qualitative standards and/or the quantitative standard are met.[77] "Own account" would mean accounts: (i) held in the name of that person; (ii) held in the name of a person over whom that person exercises control[78] or with whom that person is under common

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75 *Id.*

76 Other than those expressly exempt, i.e., RICs and persons that have or control total assets of less than $50.

77 Proposing Release, *supra* note 2, at 23074.

78 "Control" would have the same meaning as Exchange Act Rule 13h-1, i.e., the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of securities, by contract, or otherwise. *Id*. at n. 181. Any person that directly or indirectly has the right to vote or direct the vote of 25 percent or more of a class of voting securities of an entity or has the power to sell or direct the sale of 25 percent or more of a class of voting securities of such entity, or in the case of a partnership, has the right to receive, upon dissolution, or has contributed, 25 percent or more of the capital, is presumed to control that entity. *Id.*

control; or (iii) held for the benefit of persons identified in (i) or (ii).[79] Accounts under the proposed $50 million threshold would still need to be considered for purposes of determining whether their activities or trading volume, in the aggregate, meet either the qualitative or quantitative standard. The proposed "own account" definition would exclude several types of accounts.[80]

The Commission's proposed aggregation methodology would further complicate a rulemaking that is already replete with unresolved issues. Instead of engaging in their day-to-day activities, market participants will be forced to constantly monitor their trading activities and their volume (for government securities) across all subsidiaries and clients to determine whether either the qualitative standards or quantitative standard are triggered. Even if the qualitative standards do not appear to be met, the Commission could engage in an after-the-fact analysis to determine that such trading had the "effect" of providing liquidity and take remedial action against that market participant.

The Proposal does not seem to appreciate the possibility or likelihood that independent decision makers within the same parent entity or set of subsidiaries could engage in similar trading strategies that would implicate the proposed qualitative standards or quantitative standard. For example, it is entirely reasonable, and perhaps highly likely, that a portfolio manager for Hedge Fund A and a portfolio manager for Hedge Fund B, under common control of RIA C, enter similar enough trades in a large cap stock that, if their activities are aggregated, Qualitative Standard 1 or Qualitative Standard 2 would be implicated. These activities would therefore be attributed to RIA C, which would be required to register as a dealer.

Such an outcome goes back to the issues and unresolved questions we raise above regarding the application of the dealer regulatory framework to private funds and private fund advisers. The Commission provides no guidance on the application, or workability, of the dealer regime to private funds and private fund advisers. Furthermore, there is no reason why entities under common control should be required to aggregate their positions; this is entirely inconsistent with the traditional understanding of dealing.

If the Commission is going to subject private funds and private fund advisers to the Proposal, it should provide some clarity regarding its application and remove the aggregation requirements (including the "under common control" element).[81] Of course, even if the aggregation requirement were

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[79] *Id.*

[80] The excluded accounts would include: (i) accounts in the name of a registered broker-dealer, government securities dealer or RIC would not need to be considered because they are all subject to their respective regulatory regimes; (ii) 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 client of an RIA, unless those accounts constitute a parallel account structure; and (iii) accounts held in the name of an RIA's client would not need to be considered, unless the RIA controls the client as a result of: (a) the right to vote or direct the vote of voting securities of the client; (b) the right to sell or direct the sale of voting securities of the client; or (c) the RIA's capital contributions to or rights to amounts upon dissolution of the client. RIAs would be excluded from aggregating their trading activities with those of their clients when the RIA and client only have a discretionary management relationship, i.e., the RIA does not have control of the client by any of the above noted means. *Id.* at 23074-76.

[81] Along with eliminating the proposed quantitative standard and Qualitative Standards 1 and 2.

removed, it would not resolve the question regarding how the dealer regulatory framework would work for private funds and private fund advisers. Accordingly, we would reiterate our request to exclude private funds and private fund advisers from the scope of any final rule.