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VIA ELECTRONIC SUBMISSION

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

Re: Request for Comment Regarding SEC Release No. 34-94524 (File No. S7-12-22): Further Definition of "As a Part of a Regular Business" in the Definition of Dealer and Government Securities Dealer

Dear Secretary Countryman:

On behalf of a group of clients that are registered investment advisers to private funds ("**Clients**"), Fried, Frank, Harris, Shriver, & Jacobson LLP is providing this letter commenting on Release No. 34-94524, "Further Definition of 'As a Part of a Regular Business' in the Definition of Dealer and Government Securities Dealer", as published in the Federal Register on April 18, 2022 (the "**Release**"),[1] of the Securities and Exchange Commission (the "**SEC**"), and the proposal (the **"Proposal**") therein to expand the definitions of the terms "dealer" and "government securities dealer" (collectively, "**dealer**") in the Securities Exchange Act of 1934 (the "**SEA**") and the related registration requirements.

To summarize the below discussion, we believe that the SEC's proposed expansion of the "dealer" definitions is inconsistent with the plain language and historical understanding of that term as used in the SEA, such that implementation of the Proposal would require an amendment of the SEA by an act of Congress. Leaving aside the issue of statutory authority, we are of the view that the reasons given in justification of the expansion of the dealer definitions, and the related registration requirements, are insufficiently supported. In addition, it is our view that the SEC's estimates of the both the indirect impacts and the direct costs of regulation are understated. As to the indirect impacts, it is our view that the SEC gives insufficient weight to the potential negative collateral consequences of the Proposal, as firms either reduce the level of their securities activities or withdraw entirely from certain activities or markets. Any such withdrawal has the potential to be particularly damaging as to trading in U.S. government securities, given, as the SEC itself acknowledges in the Proposal, the very large increases in the amount of government securities outstanding and thus the significance of that market to the U.S. government. As far as the direct costs of regulation, we believe that the SEC has understated these costs as to registered firms, most significantly the costs resulting from the impact of the net capital rules.

Whether or not the SEC has authority to cover as "dealers" firms that, as a primary element of their trading strategy, simultaneously and continuously post both bids and offers in a specific instrument at or near the

[1] Further Definition of "As a Part of a Regular Business" in the Definition of Dealer and Government Securities Dealer, 87 Fed. Reg. 23054 (Apr. 18, 2022) (the "**Proposed Rules**").

national best bid and offer,[2] it is our view that the SEC is required to conduct a more rigorous analysis of the potential benefits, and a more comprehensive analysis of the costs, of the proposed expansion of the dealer definitions and the related registration requirements. Further, this activity has not historically been treated as a dealer activity where the firm posting quotes did not hold itself out to customers.

Section I of our letter discusses the lack of textual or historical basis for the SEC's expanded definition of the term "dealer." Section II reviews the problems that the SEC believes are caused by maintaining the current historical understanding of those terms and the reasons why the SEC believes that the registration requirement would address such supposed problems. Section III discusses some of the costs that we believe that the SEC has ignored or understated. Finally, Section IV turns to both the very significant practical problems in implementing the Proposal and to what we believe would be potentially material negative collateral consequences.

I. The SEC's Historical Understanding of the Term "Dealer"

The Release proposes to expand the definition of dealer by expanding the term to include, among other activities: (i) traders that engage in a variety of arbitrage activities; (ii) traders that simultaneously post bids and offers in substantially the same security; and (iii) as to government securities only, traders that go over a certain trading volume during prescribed periods. Additionally, the Release proposes to determine *not* whether the actor participated with the stated intention, but whether the actions had the stated effect, which can only be determined after the fact. Finally, the Proposal considers all activities occurring under a parent umbrella enterprise in aggregate, even if the actual trading and investment decisions are made, as is the case with some Clients, by separate trading desks that make trading decisions independently.[3]

In support of this expanded dealer definition, the SEC points to some ambiguity of the phrase "regular business," as used in the dealer definition, but in doing so, the SEC departs, without reasoned explanation, from its own historical interpretation.

A. The Fairfield List of Dealer Activities

For decades, the SEC has identified the activities that (in the SEC's view) have historically been considered to be those of a "dealer." A statement of these activities is set out in a series of letters issued by the SEC after the adoption of the Government Securities Act of 1986, including the "Fairfield" letter that is cited in the Release.[4] The Fairfield list of dealer activities is set out below:

(1) issuance or origination of securities;

(2) participation in a selling group or underwriting securities;

(3) purchasing or selling securities as principal from or to customers;

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2 To be consistent with the terminology used in the Release, we will refer to firms that engage in this activity as principal trading firms ("**PTFs**"), although that term applies to a significantly broader population than those engaged in the relevant activity.

3 By way of example, a Portfolio Manager (as defined below) of a Client might post a "bid" in a particular security and another, wholly independent, Portfolio Manager of the same Client, with an entirely distinct trading strategy, might post an "offer" for the same security. The SEC's Proposal would conflate the bid and the offer, and treat them as a "dealing" activity, even though there is no relationship between the decision to post the bid and the decision to post the offer and they are not part of a common strategy.

4 *See* Release at 23058; *see also* Fairfield Trading Corp., SEC Staff No-Action Letter (Jan. 10, 1988). We note that the Fairfield list was specifically relevant to U.S. government securities, but the listed activities were understood to be comprehensive as to securities generally.

(4) carrying a dealer inventory;

(5) quotation of a market in securities or publication of any quotes;

(6) advertising or otherwise holding itself out as a securities dealer, such as holding itself out as being willing to buy and sell particular securities on a continuous basis;

(7) rendering any incidental investment advice;

(8) extending or arranging for the extension of credit to others;

(9) running a book of repurchase and reverse repurchase agreements on securities; and

(10) using an interdealer broker to effect any securities transactions.

Notably, the Fairfield list of "dealer" activities does not include any of day trading, arbitrage, or registration based upon the volume of securities purchased or sold.

B. Volume Does Not Make a Firm a Dealer

Rather than focusing on the statutory language, or the Fairfield list, or the other factors that the SEC has historically maintained render a firm a "dealer," the Release instead takes the position that dealer status is determined by either the volume of trading that a firm does in a particular asset class (*i.e.*, U.S. government securities) or by the fact that the firm earns its income through the purchase and trading of securities.

Historically, the SEC has never taken the view that mere volume of trading makes a firm a dealer, or that a relatively smaller volume precludes a determination that a firm is a dealer. In fact, an SEC letter issued shortly after Fairfield explicitly rejects requiring registration based on the volume of trading.[5]

Rather than attending to the historical understanding stated in the United Trust Company no-action letter, the Release searches for out-of-context statements in other releases to bolster its new definition. For example, the Release cites *to SEC v. River North Equity*, which involved a firm that regularly purchased deeply discounted microcap stocks and sold them to retail customers.[6] There is language in that case that the court considered the volume of the defendant's trading. However, that was at most an additive factor. Viewed in context, River North Equity was engaged in underwriting or distributing microcap stocks to retail investors and engaged in a customer business with both issuers and purchasers. In short, viewing River North Equity as a dealer is fully supported by the Fairfield list and does not lend meaningful support to the Proposal.

In the same vein, the Proposal points to language in the *Sodorff* enforcement action, which pointed out that the entity must be involved in more than a few isolated transactions in order to be a dealer; *i.e.*, that there must be some volume of activities.[7] But in *Sodorff*, the SEC also made clear that Sodorff was soliciting investors, handling their money and securities, giving investment advice, and sending subscription agreements. *Sodorff* did not focus only on the volume of purchases and sales; it looked to the activities that fall on the Fairfield list.

5 *See, e.g.*, United Trust Company, SEC Staff No-Action Letter (Sept. 6, 1978) ("the level of a firm's activity with respect to . . . securities is not the measure of whether it is "engaged in the business" of buying and selling . . . securities for its own account").

6 *SEC v. River North Equity LLC*, 415 F. Supp. 3d 853, 858-859 (N.D. Ill. 2019)

7 *In re Gordon Wesley Sodorff, Jr.*, 50 S.E.C. 1249, 1992 WL 224082 (Sept. 2, 1992) ("**Sodorff**")

In short, these cases and others cited throughout the Proposal do not focus solely on the volume of purchases and sales by the relevant entities; they are taking account of the volume of those activities that fall on the Fairfield list; *e.g.*, underwriting, providing services to customers, and soliciting sales. Read in their totality, the cases do not support the view that simply buying and selling securities in the market, where there is no interaction with customers, requires dealer registration.

The SEC cites to a 2002 release proposing exceptions and exemptions from the definitions of "broker" and "dealer" to banks as part of the SEC's implementation of the Gramm-Leach-Bliley Act of 1999, when discussing volume of trading activity as indicative of dealer activity.[8] However, the 2002 Release states that dealers "normally have a regular clientele, hold themselves out as buying or selling securities at a regular place of business, have a regular turnover of business (or participate in the distribution of new issues), and generally transact a substantial portion of their business with investors."[9] The 2002 Release also emphasized that activity indicative of dealer status included: "(1) underwriting; (2) acting as a market maker or specialist on an organized exchange or trading system; (3) acting as a *de facto* market maker whereby market professionals or the public look to the firm for liquidity; or (4) buying and selling directly to securities customers together with conducting any of an assortment of professional market activities such as providing investment advice, extending credit and lending securities in connection with transactions in securities, and carrying a securities account."[10]

C. Buying and Selling for Profit Does Not Make a Firm a Dealer

The SEC seeks to expand beyond the "Fairfield" list, not to mention the statute, by interpreting the term "regular business" more broadly to essentially include potentially numerous investment funds, whether registered or not, the principal business activity of which is investing in or trading securities, but which do not do so for the purpose of serving customers. However, that is in contrast to 90 years of the SEC's own interpretation of the phrase "regular business." Moreover, there are other statutes that must be accounted for and given meaning, most importantly the Investment Company Act of 1940 (the "**ICA**"). We believe it would not be appropriate for the SEC to give the phrase "regular business" an expanded interpretation now. In this regard, we note that Section 3 of the ICA defines an "investment company" as a firm that "is or holds itself out as being engaged primarily . . . in the business of investing, reinvesting or trading in securities." The Release does not attempt to explain the difference between the statutory definitions of "dealer" in the SEA and of "investment company" in the ICA. Indeed, if the term "dealer" in the SEA is to be read as broadly as the Release suggests, then the dealer definition would swallow up to a good part of the investment company definition, since investment companies are, just like broker-dealers, in the business of trading securities.[11]

In short, the argument made in the Release proves too much or, more exactly, covers too much. In fact, perhaps the best evidence of the novelty of the SEC's Proposal is the fact that the SEC thinks it necessary

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8 Definition of Terms in and Specific Exemption for Banks, Saving Associations, and Savings Banks Under Sections 3(a)(4) and 3(a)(5) of the Securities Exchange Act of 1934, Exchange Act Release No. 46745 (Oct. 30, 2002) ("**2002 Release**") (citing SEA Release No. 34-11742 (October 5, 1975) (noting that a bank might be subject to registration as a municipal securities dealer if it engaged in underwriting, maintain a trading account or carried a dealer inventory, advertised itself as a dealer or otherwise held itself out as a dealer)).

9 *Id.*

10 *Id.*

11 It is worth noting that in order to satisfy the applicable requirements of the Administrative Procedure Act (the "**APA**") the SEC would be required to explain why it is reversing course from its long-held interpretations of the separate definitions. *See FCC v. Fox Television Stations, Inc*., 556 U.S. 502, 514 (2009); *see also Dep't of Homeland Sec. v. Regents of the Univ. of Cal.*, 140 S. Ct. 1891, 1913 (2020) ("When an agency changes course . . . it must be cognizant that longstanding policies may have engendered serious reliance interests that must be taken into account." (internal quotation marks omitted)).

to provide an exemption from the definition of dealer to SEC-registered investment companies. In the absence of the SEC's radically expanded definition of the term "dealer," no one would have thought that such an exemption would be necessary because investment companies do not have customers or provide services to outside parties (they only seek to make a return for their investors). Even more evidence of this is provided by the fact that the ICA excludes dealers in securities from the definition of "investment company." That is, Congress excludes dealers from being "investment companies" because they are already sufficiently registered; the Proposal would turn the statutory scheme on its head by excluding investment companies from the definition of dealer, which is inconsistent with the statutory scheme.

To understand why investment companies are not dealers, it is useful to turn back to the Fairfield list. The Fairfield list makes clear that the key element of being a dealer is providing services to customers; *e.g.*, underwriting, providing investment advice, and arranging or extending credit. Firms such as investment companies, including SEC-registered investment companies, do not provide services to customers and thus are not within the Fairfield list, nor within the SEC's historical interpretation of what it means to be in the dealer trade or business.

While the SEC would provide an exemption from the dealer definition for registered investment companies, it does not provide an exemption from the dealer definition for other types of entities that trade in a manner similar to registered investment companies; *e.g.*, public and private pension plans, foundations, and unregistered investment companies such as private funds and their managers. That is, there are many types of firms that trade only for the purpose of benefitting their own investors and not for the purpose of serving customers or counterparties.

D. Other Expansions of the Dealer Definition

Just as mere volume of trading does not make a firm a dealer, neither is there support for the assertion that the other activities suggested by the SEC make a firm a dealer.

The expansion of the dealer definition to include "day trading" (that is, going flat at the end of a business day) is problematic because the Proposal seems to require the integration of unrelated trading strategies that may be housed in the same legal entity or even that may be in different legal entities. That is, there is simply no policy justification to asserting that a sale by persons making investment decisions on behalf of investment funds (a "**Portfolio Manager**") must be aggregated with a purchase by another Portfolio Manager when the two managers are making trading decisions independently and neither is engaged in a strategy that the SEC would consider "dealing," even under its new expanded definition.[12] However, if the transactions of the two Portfolio Managers are conflated, it may very well be that the overall result is for the firm to be flat at the end of the trading day, simply by the happenstance of the combination of the unrelated activities of the two independent Portfolio Managers.

Firms that utilize relative value or arbitrage strategies seek to profit from related transactions and do not seek to build a customer business or trade to accommodate others. Rather, they seek to profit by trading based on finding mismatches between the values of two or more assets, an activity that does not fall within the historical definition of dealer. Further, such firms are understood to provide an extremely valuable service to the markets by acting to eliminate or narrow price discrepancies that do not seem well founded in economics. Thus both the SEA and the underlying rules provide a number of examples of provisions that are intended to favor arbitrage activities, and none of those provisions suggest that such activities are exclusively dealer activities or indicators of acting as a dealer. By way of example, the SEC's 2019 ETF

[12] We note that there are number SEC rules and interpretations that acknowledge that it is not appropriate to require the integration of all activities that are in the same legal entity (*see, e.g.*, Regulation SHO, which provides for aggregation units). Similarly, the prohibition on trading on material nonpublic information recognizes that firms may have information barriers in place to prevent the sharing of information between such units.

adopting release highlights the importance of arbitrage activities and the benefits that such activities effectively provide to retail investors, noting that when arbitrage works effectively, it keeps ETF shares functioning effectively and close to NAV and emphasizing that such mechanism is important and helps ensure investors are treated equitably.[13]

II. Supposed Problems to Solve and Benefits of Dealer Registration

The benefits that the SEC hopes to achieve by virtue of expanding the dealer definitions seem extremely speculative, and certainly short of any benefits that may justify this proposed expansion of the definitions. These include (i) the SEC's desire for more information, (ii) supposed competitive inequalities, (iii) customer protections, (iv) an absence of public confidence caused by the fact that certain firms are not registered, and (v) increased transparency, market integrity and resiliency.[14] While we will consider these hoped-for benefits in turn, we also first emphasize that no purported benefit from expanding the definition of the term "dealer" is sufficient in the absence of any statutory authority for such expansion.

A. The SEC's Desire for More Information

It seems that the principal benefit that the SEC believes it may obtain from enhanced dealer registration is that it will be able to obtain more information about the market, particularly as to transactions. In this regard, the SEC points particularly to its inability to explain the developments in the United States Treasury market and events such as the "flash rally" in October 2014.[15] However, the SEC has access now to an unprecedented amount of market information, and between new rules and amendments coming into effect, and other SEC new rule proposals, the SEC should have, or be able to obtain, more than sufficient data to accomplish its stated purpose.

We would note that in the limited case of PTFs, it is possible that their forced registration could provide the SEC with more trading data. To the extent that is true, the SEC would have a more compelling case (although still subject to statutory authority) to require registration, but in that context the SEC should draft a proposal more limited to PTFs that does not include a host of firms that are clearly not dealers and as to which the SEC already has sufficient access to information. However, we also note that transactions done by PTFs are already reported by ATS platforms (with a client identifier) or by broker-dealer counterparties, even though PTFs are not FINRA members and do not themselves report transactions to TRACE.

We list below certain of the information that is or will be in the SEC's hands.

TRACE. TRACE effectively provides the SEC with real-time or near real-time reporting as to transactions in most debt securities, including U.S. government securities by broker-dealers. TRACE was recently expanded and requires banking institutions that are government securities dealers to report all United States treasury transactions that they are party to, regardless of whether the institution is acting in a dealer capacity or whether activity was with clients inside or outside the United States.[16] FINRA will collect detailed data

13 *See* Exchange Traded Funds, 84 Fed. Reg. 57162, 57165 (Oct. 24, 2019).

14 Other purported benefits include: closing regulatory gaps, ensuring consistent oversight, regulating unregulated liquidity providers, distinguishing between retail and institutional investors in the dealer context. *See also* Release at 23068 ("by competing to both buy and sell at the best available prices, liquidity providers help to narrow bid-ask spreads. The Commission further believes that the proposed formulation helps emphasize that a liquidity provider, to come within the rule, must both buy and sell securities.").

15 Release at 23056.

16 *See* FINRA Technical Notice, *Trade Depository Institution Reporting* (Feb. 16, 2022). Every national bank, state member bank, state non-member bank, savings association, or U.S. branch and agency of a foreign bank filing a Notice of Government Securities Broker or Government Dealer Activities Form with average daily transaction volumes of over $100 million for U.S. Treasury securities, or over $50 million for agency-issued debt and MBS,

on depository institutions' daily transactions of marketable U.S. Treasury securities and of the debt and MBS issued by the U.S. federal government agencies including government-sponsored enterprises via TRACE.

Consolidated Audit Trail ("CAT"). With the exception of fixed income transactions, all broker-dealer proprietary trading activity, including market making activity, is subject to CAT reporting, with no exclusions or exemptions of any kind for size or type of firm or type of trading activity. Information included in reporting should include (if applicable): account holder type, buy/sell side, cancel quantity, route event quantity, trading session code, new order code, department type code, time in force, handling instructions, and representative indicator.[17]

Form PF. Form PF already provides the SEC with substantial information as to private funds.

13H Reporting. The SEC is able to identify "large traders" as to all of their activities across all U.S. broker-dealers by virtue of the fact that such large traders are required to obtain an identifying number and provide the SEC with information as to all the firms with which they trade

The SEC states that requiring further entities to register as dealers would enable the SEC to obtain additional information than it already has or to which it will have access. While this may be true as a literal matter, any such informational gain would be at best extremely nominal given that between TRACE and CAT, the SEC already has trade reporting information as to all material transactions in the securities markets. (To the extent that banks do not provide real time trading information as to government securities, that is a limitation imposed by the banking regulators, including Treasury, which is primarily responsible for the government securities market.)

Given how much information the SEC already has, the SEC should explain in reasonable detail the additional information that it hopes to obtain, as well as why this additional information is of substantial value to the SEC. In fact, the Release itself suggests that there is no assurance that the SEC will obtain any benefit from the information. Rather, the SEC says that with the information that it had at the time, the SEC could not identify the cause of a "flash event" in the government securities markets; there is no reason to believe that it could identify the cause with more information or that knowing the cause would mean that the event was preventable; nor is there any evidence that the "costs" of the event to the financial system justify some new and expansive registration requirement.

To the extent that the SEC does identify any material informational gaps, the SEC could explore whether additional recordkeeping requirements are appropriate. We note that the APA requires the SEC to consider less burdensome alternatives.

B. Competitive Inequalities

The SEC points to "competitive inequalities" as a reason to require registration of additional firms as securities dealers. Claiming any such inequalities puts the cart before the horse. First, the SEC must demonstrate that the firms that are within the existing definition of dealer benefit from a competitive inequality. If the beneficiary firms are not within the existing definition, then they are not beneficiaries of an inequality because they are not engaged in the same activities as those firms that are within the existing definitions.

C. Customer Protections

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during the prior fiscal year will be subject to the reporting requirements. This expansion of existing reporting requirements is effective September 1, 2022.

17 *See* 2022 Report on FINRA's Examination and Risk Monitoring Program, pp. 42-43 (Feb. 9, 2022).

The SEC states that customers are denied of protections because of the absence of dealer registration for trading entities, but the reason that the trading entities are not required to register as dealers is that they do not have customers. If these firms had customers, then they would have a "trade" or "business" of dealing securities, in the meaning that those terms have been historically given, and they would therefore already be required to register as dealers in securities.

In short, the trading firms that the SEC would require to register as dealers (i) do not engage in underwriting, (ii) do not distribute or originate securities, (iii) do not carry customer accounts or provide custody, (iv) do not execute trades as agent, (v) do not provide recommendation or investment advice, (vi) do not trade to accommodate others, (vii) do not extend credit to facilitate others, and so on. As these firms do not have customers, imposing customer protection obligations on these firms will not benefit any customers.

In fact, calling these firms "dealers" would deny these firms, including investment funds they advise (and indirectly their investors) the benefits of the "customer" protections that they now are entitled to receive when they trade with dealers. Firms denied these protections may no longer have an absolute right to best execution, will no longer have the right to receive confirmations, and will no longer have their assets protected by the full measure of Rule 15c3-3, but will instead have their assets in a so-called PAB account. In fact, by depriving these firms (and indirectly their investors) of customer status, the SEC would be reducing, not increasing, the benefits to ultimate investors in the affected funds. For example, when a major investment bank, Lehman Brothers, filed for bankruptcy, most private funds that had significant securities positions held at Lehman were able to obtain substantially full recovery as customers of Lehman. Had the Proposal been in effect, those funds and, indirectly, their investors, could instead have experienced substantial losses.

D. Absence of Confidence

The SEC makes reference a number of times to there being a lack of "confidence" in the markets.[18] However, we are not aware of any demonstration of any lack of confidence in the markets. Further, if there were any such lack of confidence, one could propose any number of sources for it from the events with respect to GameStop to the events relating to Archegos to the recent declines in equity values. None of these events has anything to do with who is or is not registered as a dealer and the Proposal would not address any of these events.

A major rule expansion should depend on more than the assertion, without statistical support, that there is a lack of "confidence" in the market and that confidence would increase because of a measure that appears wholly unrelated to the significant concerns of the day.

E. Transparency, Market Integrity and Resiliency

The SEC claims that the increase in the level of government securities debt is a justification for registration. On the other hand, the size of this market and the U.S. government's need for a highly liquid secondary market to support its issuances, means that the Proposal may have the effect of causing substantial pools of capital that trade actively in the government securities markets to either no longer participate, or to reduce participation, in those markets in order to avoid registration, or because they cannot as a practical matter register due, among other things, to the significant additional capital charges, imposition of FINRA regulation, and other costs of becoming a registered dealer.

The Release makes various references to protecting "market functionality," but it is not obvious what this means or how this justifies the Proposal. The Release also makes reference to "operational resiliency"

18 *See, e.g.*, Release at 23088.

being improved if more firms were required to register as dealers. However, it is not clear how the SEC defines such resiliency or measures it, or why the SEC believes that resiliency would be improved if more firms were registered as dealers. Before the SEC adopts a broad expansive rule on the basis of improvements to either "market functionality" or "operational resilience," the SEC should better define those terms, and demonstrate how they are impaired under the current regime and how they would be improved by virtue of the Proposal.

III. <u>Costs of the Rule: Focus on Capital</u>

The estimate of the costs of dealer registration identified in the Release focuses a good bit on administrative requirements; *e.g.*, even down to the costs of sending mail, but understates very significant costs or ignores meaningful economic costs entirely.

As a relatively minor point, it is our understanding, based on our conversations with market participants and service providers, that the clerical and administrative costs to broker-dealers of regulatory compliance are many times higher than the SEC makes them out to be. These numbers ought to be readily estimable by the SEC since, in contrast to estimating the costs of new rules, the SEC should be able to survey existing firms that are engaged in activities that the SEC asserts are similar and see how much those costs are. It does not appear that the SEC has done so.

Much more importantly, however, under the APA the Commission should conduct a fulsome review of the full economic costs that the Proposed Rules would impose on a new class of registrants, as well as the markets more broadly, including a study and analysis of the reasonably anticipated effects of firms withdrawing from relevant markets and thereby reducing liquidity in those markets. No meaningful analysis of these much more important factors appears in the Release. While that analysis might be difficult and time-consuming, reasonable estimates are possible and, in any event, the analysis is mandated by the APA.

We will focus below on a single type of cost, that of capital, which may be the most significant among the direct costs to registrants.

A. <u>Permanent Capital</u>

Before we turn to the amount of capital that firms will require to comply with Rule 15c3-1 under the Securities Exchange Act, the "net capital rule," we begin with pointing out that compliance with that rule generally requires that firms have a substantial amount of permanent equity capital that can not be redeemed by investors within a period of less than a year and may not be permitted to be redeemed at all if the withdrawal would cause the firm to fall below certain capital limits. Even "subordinated debt" that counts as capital for purposes of the SEC's net capital rule is subject to strict limits on withdrawal rights. Therefore, any attempt at quantification of the costs of dealer registration, as opposed to operation as a private fund without registration, must begin with some attempt at quantifying the cost of "permanent capital" in a broker-dealer that does not have publicly-traded securities and for which there is no exit, as opposed to an investment in a private fund that offers periodic redemption rights. We recognize, of course, that a private fund might provide permanent capital to a subsidiary broker-dealer, but if (as is usually the case) the private fund's capital is subject to potential withdrawal rights, then committing permanent capital to a subsidiary will involve unacceptable risks in many cases, and in any event would require additional disclosure to investors and a potential renegotiation of the terms of investment. None of those costs are recognized in the Release.

While these costs may not be easily determined, they are estimable, and they are far more significant than the administrative costs that are identified in the Proposal.

B. Equity Required to Obtain Compliance with the Net Capital Rule

Once the SEC has determined a reasonable cost of permanent capital, the SEC is then next obligated to determine how much permanent capital a firm would be required to maintain. It is not sufficient to do this for a firm that trades only in U.S. government securities, as to which the costs of capital are low relative to the cost of capital for other types of securities. Nor would it be sufficient to calculate the cost of capital only as to listed equities, for the scope of the Proposal is significantly broader.

We also observe that any realistic attempt to calculate the cost of capital would be required to take into account that a firm that might be subject to the registration requirement will very likely have numerous positions that would not be within the scope of the Proposal's definition of dealer. It is very likely that the cost of capital for these positions will actually be much greater than the cost of capital for positions that the SEC's expanded definition would put within the scope of "dealer." Accordingly, either the SEC must attempt to consider the cost of carrying these positions within a regulated dealer or it must consider the costs of establishing a second entity that is not a dealer to carry these positions.

We read the Release to indicate that the SEC has not quantified these costs, and perhaps has suggested that it does not have any basis on which to do so. We are confident that the SEC would be able to reasonably estimate these costs if it attempted to do so. Many investment funds and other trading vehicles are managed by registered investment advisers that are required to keep detailed position records under the Advisers Act. By reviewing the records that registered investment advisers are required to keep, even just end of month trading positions, the SEC should be able to make a realistic assessment of the amount of equity required to obtain compliance with the net capital rule.

Once the SEC has determined the costs of permanent capital and the amount of net capital required to operate as a dealer, then the SEC may begin to make a determination of at least the costs of equity. However, it would then also be necessary to make a reasonable estimate of the expenses of determining and reporting compliance.

C. Operational Expenses of Compliance with the Net Capital Rule

In assessing the costs of regulatory compliance with the net capital rule, the SEC focuses primarily on the filing of a form with the SEC on a monthly basis. However, dealers are required not only to be in constant compliance with the net capital rule, but to know their net capital amounts (at least within some reasonable degree) at all times.

The net capital rule is not a simple one. Any firm that would become subject to the rule would require at a minimum the following:

- a technology that is capable of constantly monitoring its systems and calculating the firm's net capital amount on an ongoing basis
- a financial and operations professional who is qualified with FINRA and who is able to certify the firm's position to the SEC and FINRA, and additional support staff; and
- outside accountants that are qualified to sign off on the necessary reports.

It is our belief that not only are these costs fairly substantial, they have not been taken account of in the Release. Further, the SEC should be able to make a reasonable estimate of these costs since they are costs that would be borne by firms that are already registered with the SEC.

Finally, of course, there are the expenses involved in FINRA registration, in responding to inquiries (which may not involve any violations of applicable law or regulation) by FINRA and/or the SEC and the like.

FINRA and the SEC impose a very substantial regulatory burden on registrants, and the costs of appropriate oversight and compliance monitoring are very significant.

IV. Unintended Consequences

It is our impression that the SEC has not given full consideration to the negative collateral consequences that are likely to flow from the expanded definition of dealer. We suggest below some of the potential consequences that the SEC should consider, all of which merit significant further study and analysis before any Proposal is adopted:

- Firms will be required to stop or diminish trading activities either because they simply are not able to comply with the dealer registration requirements (the costs of reorganization or of raising permanent capital are too high) or because it is not economically reasonable to do so. Given that the activities of these firms generally serve to reduce the size of bid-offer spreads or to eliminate price differences that are not economically justified, bid-offer spreads should increase and there should be fewer firms engaged in arbitrage activities.
- A reduction in the number of firms engaged in arbitrage or relative value strategies, or a reduction in the amount of such activities, will have a negative impact on those products whose values depend on such activities. There will be a negative impact on the pricing of ETFs, and it will become more likely that the market value of an ETF will diverge from the value of the underlying shares held by the ETF. This is most likely to be to the detriment of retail investors who are less able than institutional investors to determine whether an ETF is mispriced on the high side or on the low side as compared to the underlying basket of securities that the ETF holds.
- If a material number of firms are motivated or required to reduce their positions or to exit markets, then there could be meaningful downward selling pressure put as firms liquidate the relevant positions.
- An increase in bid-offer spreads, which increases the costs of trading, should to at least some extent raise the cost of capital for issuers generally. As the largest issuer of securities is the U.S. government, even a small increase in the cost of capital to it may be a meaningful amount.
- Pension plans, foundations, corporations and other similar organizations may be required to withdraw from activities that could subject them to registration or force them to invest in permanent capital broker-dealers, activities in which they may not be permitted to engage.

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If the SEC or the staff of the SEC have any questions, or wish to discuss the matters mentioned in this letter, please contact Steven Lofchie at [redacted]

Very truly yours,

Fried, Frank, Harris, Shriver & Jacobson LLP