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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

August 21, 2023

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] writes to supplement our letters dated May 27, 2022 and November 17, 2022 regarding the U.S. Securities and Exchange Commission's ("SEC" or "Commission") proposed rule to redefine the phrase "as part of a regular business" as used in the statutory definitions of "dealer" and "government securities dealer" (the "Proposal").[2] We appreciate the Commission's recent determinations to reopen the comment periods for several of its proposed rules.[3] The reopening releases explain that the reason for doing so is to invite comments on the

[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 $800 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] Proposed Rule, "Further Definition of 'As Part of a Regular Business' in the Definition of Dealer and Government Securities Dealer", 87 Fed. Reg. 23,054 (April 18, 2022) (the "Dealer Proposal"). AIMA's responses to the Dealer Proposal can be found here and here.

[3] *See* Proposed Rule; Reopening of Comment Period, "Cybersecurity Risk Management for Investment Advisers, Registered Investment Companies, and Business Development Companies", 88 Fed. Reg. 16,921 (Mar. 21, 2023) (the "Cybersecurity Reopening"); Proposed Rule; Reopening of Comment Period, "Reopening of Comment Period for Modernization of Beneficial Ownership Reporting", 88 Fed. Reg. 28,440 (May 4, 2023) (the "Beneficial Ownership Reopening"); Proposed Rule;

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aggregate and/or overlapping effects of some of its other proposed rules.[4] Other reopening notices have been accompanied by additional analysis of the proposed rule from the Commission's Division of Economic and Risk Analysis ("DERA").[5] In the spirit of these developments, we strongly encourage the Commission to pause any consideration of adopting the Proposal so that DERA may conduct additional economic analysis regarding the Proposal's market impact and further assess the number of market participants that will be required to register (or withdraw/limit their trading and investing activity) as a dealer or government securities dealer under the proposed quantitative standard and qualitative standards.

Statutory Authority

At the outset, we believe the changes contemplated in the Proposal exceed the Commission's authority and violate the Securities Exchange Act of 1934's (the "Exchange Act") definition of "dealer", the Exchange Act's legislative history, the Congressional intent and the general understanding – for almost 90 years – of what a dealer (or government securities dealer) *is* and its role in effectuating *customer* orders. The Proposal, however, is not the Commission's only current effort to change this well-understood and settled definition.

The Commission has brought multiple enforcement actions[6] against investors whom it deems to have been operating as unregistered securities dealers under the theory that any person whose business activities involve, as an incident thereto, purchases and sales of securities is a "dealer".[7] The Commission totally disregards the historical meaning and application what it means to be "in the business of buying and selling securities" under the Exchange Act's dealer definition.[8] Its newfound

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Reopening of Comment Period, "Supplemental Information and Reopening of Comment Period for Amendments Regarding the Definition of 'Exchange'", 88 Fed. Reg. 29,448 (May 5, 2023) (the "Exchange Definition Reopening"); Proposed Rule; Reopening of Comment Period, "Reopening of Comment Period for Position Reporting of Large Security-Based Swap ["SBS"] Positions", 88 Fed. Reg. 41,338 (June 26, 2023) (the "SBS Reopening").

[4] "Reopening the comment period for the Investment Management Cybersecurity Release will allow interested persons additional time to analyze the issues and prepare their comments in light of other regulatory developments on cybersecurity", including the cybersecurity-related proposed rules the Commission issued in March 2023. Cybersecurity Reopening, *supra* note 3, at 16,921. "The Commission is reopening the [beneficial ownership] comment period to allow interested persons an opportunity to comment on the additional analysis and data contained in a staff memorandum." Beneficial Ownership Reopening, *supra* note 3, at 18,440. "The reopening of [the exchange definition] comment period is intended to allow interested persons further opportunity to analyze and comment on the Proposed Rules in light of the supplemental information provided herein." Exchange Definition Reopening, *supra* note 3, at 29,448. "The Commission is reopening the [SBS] comment period to allow interested persons an opportunity to comment on the additional analysis and data contained in a staff memorandum." SBS Reopening, *supra* note 3, at 41,339.

[5] *See* Beneficial Ownership Reopening and SBS Reopening, *supra* note 3.

[6] *See SEC v. Almagarby*, No. 0:17-cv-62255 (S.D. Fla. Nov. 17, 2017); *SEC v. Carebourn Capital et al.*, No. 21-cv-2114 (D. Minn. Sept. 24, 2021); *SEC v. Keener*, No. 20-cv-21254 (S.D. Fla. Mar. 24, 2020); *SEC v. LG Capital et al.*, No. 1:22-cv-03353 (E.D.N.Y. June 7, 2022) and *SEC v. Morningview Financial LLC et al.*, No. 1:22-cv-08142 (S.D.N.Y. Sept. 23, 2022).

[7] The Exchange Act defines a "dealer" as "any person engaged in the business of buying and selling securities . . . for such person's own account through a broker or otherwise." 15 U.S.C. § 78c(a)(5)(A). It also includes an express exemption for persons buying and selling securities "not as part of a regular business." *Id.* at 78c(a)(5)(B).

[8] *Id.*

theory lacks a limiting principle and widens the net of who could be a securities dealer to any business that buys and sells securities.

Since the Exchange Act's inception, being "in the business of buying and selling securities" has been applied and understood to mean buying and selling securities for the benefit of a *customer*, i.e., effectuating a customer's order by taking the opposite side in the dealer's account. Indeed, like the Commission recently explained in one court, "[i]nvestors in securities markets [like retail investors, hedge funds, pensions, insurers, etc.] do not interact directly with exchanges or clearing agencies but instead are customers of broker-dealers who effect transactions on investors' behalf."[9] In other fora, however, the Commission has taken a 180-degree turn from this statement.

In *LG Capital*, for example, the Commission claims that the "Exchange Act does not define what it means to be 'engaged in the business' of buying and selling securities, but LG Capital is a business: it has offices, employees, keeps accounting records, and carries on for profit. And its business model is to buy and sell securities"[10]; therefore, LG Capital is a securities dealer. Under this theory, however, any hedge fund, mutual fund, pension fund, insurance company, family office, endowment or individual investor could be a securities dealer.

This means that, even if the Proposal is adopted as is, the Commission is still not foreclosed from bringing enforcement actions – under an erroneous reading of the Exchange Act – against persons who would otherwise not be dealers under the Proposal. It appears that the Commission is seeking, through litigation, a judicial validation of a position that well exceeds the parameters of the Proposal. Moreover, it has chosen to advance this argument without exposing this re-interpretation to public comment, providing cost-benefit analysis or otherwise complying with the Administrative Procedure Act. Essentially, the Commission is proposing one definition of dealer to be adopted through the rulemaking process and another interpretation of dealer it uses in the federal courts that is even broader than the Proposal.

The SEC's reading of "dealer" in the courts is so expansive that it puts into the doubt the usefulness of the Proposal in the first place, i.e., what is the point of the Proposal if it narrows the argument the Commission is pursuing in the courts? If the courts ultimately agree with the Commission, then a final version of the Proposal would be superfluous, unless the Commission believes it can square its rulemaking (or some version thereof) with the court(s) holdings. At the very least, given that the matter is before (at least two) federal courts of appeal, we would urge that, before adopting any final version of the Proposal, the Commission await the decisions in those pending appellate cases, especially since those opinions will inevitably cast light on the proper interpretation of the statutory language.

The Necessity of the Proposal

Notwithstanding the above, the Proposal is largely unnecessary in relation to the U.S. Treasury markets because of other pending proposed rules that the Commission has concurrently issued –

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[9] Compl. ¶ 40, *SEC v. Coinbase, Inc.*, No. 1:23-cv-04738 (S.D.N.Y. June 6, 2023).

[10] *See LG Capital*, *supra* note 6, SEC Opp. to MTD 9-10 (internal citations omitted).

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specifically, the Treasury Clearing Proposal[11] and ATS Proposal[12] – that will advance many of the same objectives outlined in the Proposal. First, the Treasury Clearing Proposal would require hedge funds to clear nearly all of their cash Treasury and repo transactions, suggesting that such a requirement would enhance market integrity, resiliency and transparency.[13] The Commission notes that the benefits of the Treasury Clearing Proposal "could be particularly significant in times of market stress, as CCPs would mitigate the potential for a single market participant's failure to destabilize other market participants, destabilize the financial system more broadly, and/or reduce the effects of misinformation and rumors."[14] Moreover, the use of CCPs "would address concerns about counterparty risk by substituting the creditworthiness and liquidity of the CCP for the creditworthiness and liquidity of counterparties."[15]

Second, the ATS Proposal would expand the scope of ATS registration to a number of platforms trading Treasury securities.[16] This would significantly increase the granularity of TRACE data reported to the official sector, as counterparty market participant identifiers for non-FINRA members are required only when transactions occur on an ATS even though all TRACE transactions involving a FINRA member are reported to TRACE.[17] Together, the Treasury Clearing Proposal and ATS Proposal render the Proposal unnecessary.

If, however, the Commission insists on adopting some version of the Proposal, we strongly encourage DERA to conduct additional economic analysis of the Proposal and for the Commission to reopen the comment period for interested parties to opine on the additional analysis, similar to how it has done over the past several months.[18] Specifically, DERA should conduct a thorough assessment of (i) the Proposal's impact on market efficiency, competition and capital formation and (ii) the number of market participants that the Proposal would force to register as government securities dealers and dealers or, alternatively, would be required to withdraw from the markets.

Market Efficiency, Competition and Capital Formation

The Proposal's Economic Analysis highlights multiple, significant monetary costs and other negative effects that may result, 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)

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[11] Proposed Rule, "Standards for Covered Clearing Agencies for U.S. Treasury Securities and Application of the Broker-Dealer Customer Protection Rule With Respect to U.S. Treasury Securities", 87 Fed. Reg. 64,610 (Oct. 25, 2022) (the "Treasury Clearing Proposal").

[12] Proposed Rule, "Amendments Regarding the Definition of 'Exchange' and Alternative Trading Systems (ATSs) That Trade U.S. Treasury and Agency Securities, National Market System (NMS) Stocks, and Other Securities", 87 Fed. Reg. 15,496 (Mar. 18, 2022) (the "ATS Proposal").

[13] Treasury Clearing Proposal, *supra* note 11, at 64,614.

[14] *Id.* at 64,662.

[15] *Id.*

[16] *See generally,* ATS Proposal, *supra* note 12.

[17] *See* Dealer Proposal, *supra* note 2, at 23,086. *See also* FINRA Rule 6730.07 that requires each "Covered ATS," as defined by that rule, to report transactions to TRACE along with a unique, non-anonymous MPID for each counterparty.

[18] *See supra,* n. 3-5.

recordkeeping and reporting costs; (iii) meeting capital requirements; and (iv) continuous self-evaluation as to whether one is a dealer.[19]

The Commission acknowledges that these substantial costs may also affect market efficiency, competition and capital formation.[20] It further acknowledges that the Proposal's net effect on each of these aspects is "*uncertain*."[21] 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 (and, without question, will force at least some market participants out of the 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 (both quantifiable and unquantifiable) of becoming a dealer or a government securities dealer, some market participants will inevitably change or abandon certain investment, trading and/or risk management strategies. This will necessarily affect price discovery adversely, 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 will suffer to an as-yet unknown degree as firms change their trading behavior, leading to, perhaps, a concentration of risk in fewer firms.

Notwithstanding the quantifiable costs of becoming a dealer or a government securities dealer, it is unclear to us (and perhaps impossible) how a private fund, which is an asset holding company, can be converted into an operating company that is registered as a dealer. Transforming an asset holding entity (a private fund) into an operating entity is essentially impossible without duplicating the entire structure of operations that exists at the level of the investment adviser, thereby making this model impossible to operate. It would also create enormous costs – likely higher than any other fund costs – that would be directly payable by investors because these would be fund, not adviser, expenses.

Furthermore, if a private fund is forced to register as dealer (again, assuming it is possible), it will lose a number of customer protections. In this event, it is highly unlikely that the fund's investors will be willing to take on the additional risks associated with a reduction in customer asset segregation[22] and a number of FINRA and SEC sales practice protections.[23]

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[19] Dealer Proposal, *supra* note 2, at 23,089.

[20] *Id.* at 23,091-92.

[21] Emphasis added. "The net effect on market efficiency is uncertain." *Id.* at 23,091. "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 23,092.

[22] 17 CFR § 240.15c3-3 - Customer protection - reserves and custody of securities.

[23] *See e.g.,* FINRA Rule 2111 (Suitability), FINRA Rule 2121 (Fair Prices and Commissions); FINRA Rule 2231 (Customer Account Statements); FINRA Rule 2232 (Customer Confirmations); FINRA Rule 5130 (Restrictions on the Purchase and Sale of Initial Equity Public Offerings); FINRA Rule 5310 (Best Execution and Interpositioning); and FINRA Rule 5320 (Prohibition Against Trading Ahead of Customer Orders).

Under the Administrative Procedure Act, the Commission has an obligation to make a reasonable estimate of these costs, yet none appears in the Proposal. We respectfully question whether the Commission has fully assessed the effects the Proposal is likely to have on market participants, market infrastructure providers and securities and government securities markets. Accordingly, we strongly encourage the Commission to pause any consideration of adopting the Proposal so that DERA may conduct additional economic analysis of the Proposal's impact on market efficiency, competition and capital formation, then reopen the comment period so that interested parties may respond to the new analysis.

Impacted Market Participants

The Quantitative Standard

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,[24] but a quantitative standard does not recognize the fundamental difference between a customer – like AIMA's hedge fund members – 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.

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 principal trading firms ("PTFs") and 20 are dealers, leaving four remaining firms.[25] Of these four remaining firms, the Commission estimates that at least one hedge fund surpassed the quantitative standard; however, it acknowledges that other hedge funds may meet the quantitative standard.[26]

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 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,"[27] 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

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[24] Dealer Proposal, *supra* note 2, at 23,058-59.
[25] *Id.* at 23,081.
[26] *Id*.
[27] *Id.*

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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 accurately estimate the number of customers that would be captured.

This further underscores the need to consider the Proposal in connection with other pending rulemakings, particularly the ATS Proposal, as discussed above. The ATS Proposal, by requiring the registration of Treasury ATSs, would provide the Commission with more data on non-broker-dealer counterparties. Accordingly, the Commission should wait until the ATS Proposal is finalized and receives the material that will be derived from it before finalizing the Proposal.[28]

It is likely that a substantial number of firms impacted 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," we believe these negative consequences will materialize, a result neither the Commission, nor other federal financial regulators, should welcome.

Qualitative Standards

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").[29]

The proposed qualitative standards, particularly Qualitative Standard 1, are incredibly broad, unclear and would capture a significant amount of investing and trading that is (i) done by *customers* (hedge funds, individuals, pensions, insurers and others) of dealers and (ii) inconsistent with any reasonable notion of dealing. We believe the Commission's preliminary estimate that only 51 market participants would be required to register as a dealer or government securities dealer under the proposed qualitative standards is woefully inaccurate.[30]

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[28] Alternatively, if the Commission needs more information from non-broker-dealer market participants in the Treasury markets, there are plenty of more reasonable and less costly alternatives than forcing these market participants to register as government securities dealers.
[29] Dealer Proposal, *supra* note 2, at 23,066-67, 69.
[30] *Id.* at 23,099.

For example, Qualitative Standard 1 would capture many common hedge fund strategies that have never been, and should not now be, considered dealing, including fixed-income arbitrage, convertible bond arbitrage and capital structure arbitrage, as well as a number of relative value or quantitative strategies. At its most basic level, it appears Qualitative Standard 1 could capture simple hedging if it is done routinely and in coordination with buying and selling activity. Furthermore, simply trading securities or government securities that has the "effect of providing liquidity" could trigger required registration (or abandonment of the activity), leading to an after-the-fact assessment by the Commission whether a market participant's trading activity has provided liquidity.

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. 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.

Based on the foregoing, we strongly encourage the Commission to pause any consideration of adopting the Proposal and to direct DERA to conduct additional economic analysis to estimate the number of market participants that will be required to register (or withdraw/limit their trading and investing activity) as a dealer or government securities dealer under the proposed quantitative standard and qualitative standards. DERA can assess data beyond that considered in the Proposal's Economic Analysis, including, e.g., Form PF data, data from the Office of Financial Research, data derived from the ATS Proposal and exchange/SRO data. Once this analysis is complete, the Commission should reopen the comment period so that interested parties may assess the new analysis and respond to it.

Further Assessment

We believe that once the Commission and DERA have a better understanding of the number of market participants that will be implicated by the quantitative standard and qualitative standards, it can better assess the deeply negative impacts the Proposal is almost certain to have on market efficiency, competition and capital formation. Once this analysis is undertaken and additional public comments have been considered, we believe it will further establish that the monetary and non-monetary costs of the Proposal far outweigh any benefits the Commission believes may materialize. These incredible

costs to markets and market participants will hopefully lead to the Commission withdrawing the Proposal from any further consideration, an outcome we wholeheartedly support and encourage.

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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
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Cc: The Honorable Gary Gensler, Chair
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