Managed Funds Association
The Voice of the Global Alternative Investment Industry
Washington, D.C. | New York | Brussels

December 5, 2022

Via Electronic Submission

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

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

Dear Ms. Countryman:

Managed Funds Association ("**MFA**")[1] submits the attached economic study ("**Lewis Study**") to the Securities and Exchange Commission ("**Commission**" or "**SEC**") on the proposed rulemaking to revise and expand the definitions of "dealer" and "government securities dealer" under Sections 3(a)(5) and 3(a)(44), respectively, of the Securities Exchange Act of 1934 ("**Exchange Act**").[2] MFA commissioned Professor Craig M. Lewis, the Madison S. Wigginton Professor of Finance at Vanderbilt University's Owen Graduate School of Management and a former SEC Chief Economist and Director of the Division of Economic and Risk Analysis, to conduct an economic review and analysis of the Proposal and provide his expert opinion.

The Lewis Study demonstrates the fundamental disconnect between the stated objective of the proposed rules and what the new rules actually do.[3] Despite claiming to capture activities "traditionally performed by entities regulated as dealers," the proposed rules instead redefine the terms "dealer" and "government securities dealer" to encompass customers engaged in a wide range of ordinary investing, trading, arbitrage, hedging, and cash and collateral management. In

[1] MFA represents the global hedge fund and alternative asset management industry and its investors by advocating for regulatory, tax, and other public policies that foster efficient, transparent, and fair capital markets. MFA's more than 150 member firms collectively manage nearly $2.6 trillion across a diverse group of investment strategies. Member firms help pension plans, university endowments, charitable foundations, and other institutional investors to diversify their investments, manage risk, and generate attractive returns over time. MFA has a global presence and is active in Washington, Brussels, London, and Asia. www.managedfunds.org

[2] SEC Release No. 34-94524 (Mar. 28, 2022), 87 Fed. Reg. 23,054 (Apr. 18, 2022) ("**Proposal**"), available at: https://www.govinfo.gov/content/pkg/FR-2022-04-18/pdf/2022-06960.pdf.

[3] *See also* Letter from Jennifer W. Han, Executive Vice President, Chief Counsel & Head of Global Regulatory Affairs, MFA, to Vanessa Countryman, Secretary, SEC (May 27, 2022), available at: https://www.sec.gov/comments/s7-12-22/s71222-20129911-296085.pdf.

addition to showing this disconnect between the Commission's intended targets and those likely affected by the new rules, the Lewis Study reveals that the Proposal's economic analysis is deficient in many fundamental respects and does not justify the rulemaking. Furthermore, the Lewis Study shows that the Proposal is not only an unjustified overreach, but it also could have significant negative unintended consequences for investors and markets, in particular the U.S. Treasury market. If the proposed rules are adopted as proposed, many private funds will exit or reduce participation in the U.S. Treasury market rather than register as dealers, among other consequences. This could lead to further concentration in the U.S. Treasury market, decrease market resilience and stability, and lead to increased systemic risk.

* * *

MFA appreciates the opportunity to share the Lewis Study with the Commission and would be pleased to facilitate a meeting with Professor Lewis. Please do not hesitate to contact Matthew Daigler, Vice President & Senior Counsel, or the undersigned, at (202) 730-2600, with any questions that you, your respective staffs, or the Commission staff might have regarding this letter.

Very truly yours,

/S/ Jennifer W. Han

Jennifer W. Han
Executive Vice President
Chief Counsel & Head of Global Regulatory Affairs

cc: The Hon. Gary Gensler, SEC Chairman
The Hon. Hester M. Peirce, SEC Commissioner
The Hon. Caroline A. Crenshaw, SEC Commissioner
The Hon. Mark T. Uyeda, SEC Commissioner
The Hon. Jaime Lizárraga, SEC Commissioner
Dr. Haoxiang Zhu, Director, Division of Trading and Markets
Dr. Jessica Wachter, Chief Economist and Director of the Division of Economic and Risk Analysis

The SEC's Proposed Rules for Further Definition of "As a Part of a Regular Business" in the Definition of Dealer and Government Securities Dealer

Craig M. Lewis, Ph.D.*

December 5, 2022

* I am the Madison S. Wigginton Professor of Finance and Professor of Law at Vanderbilt University. From June 2011 to May 2014, I was Chief Economist and Director of the Division of Economic and Risk Analysis at the U.S. Securities and Exchange Commission. I acknowledge the support of the Managed Fund Association.

Table of Contents

I. Executive Summary

1. This paper evaluates the rules proposal "Further Definition of 'As a Part of a Regular Business' in the Definition of Dealer and Government Securities Dealer," proposed by the U.S. Securities and Exchange Commission ("SEC" or "Commission") on March 28, 2022 ("Proposal" or "Proposed Rules"). The Proposed Rules would create new qualitative and quantitative criteria that would require certain entities to register as dealers or as government securities dealers who historically have not been required to do so.

2. The Proposal seeks to justify itself by claiming that some market participants who are not currently registered as dealers act as "liquidity providers"[1] or "*de facto* market makers"[2] and may impose "negative externalities that may arise in relation to market participants' financial and operational risks."[3] Specifically, the Commission speculates that market participants who effectively provide liquidity but are not subject to existing dealer regulations "*may* not have sufficient incentive to ensure their ability to weather adverse shocks," and could take on financial or operational risks that cause them to fail, thereby imposing negative externalities on the rest of the market.[4] The Commission further suggests that requiring these "liquidity providers" to register as dealers will address the potential risk of the claimed negative externalities because it would subject them to the net capital requirements (Rule 15c3-1) and operational integrity rules (Rule 15c3-5) for broker-dealers.[5] In addition, the Commission attempts to justify the Proposed Rules by claiming that other aspects of dealer registration—such as trade reporting, examinations, and books and records requirements—would help the Commission detect market manipulation and fraud.[6]

3. As an initial matter, there is a fundamental disconnect between the stated objective of the Proposed Rules, and what the new rules actually do. Despite claiming to capture activities

[1] "Further Definition of 'As a Part of a Regular Business' in the Definition of Dealer and Government Securities Dealer," Release No. 34-94524; File No. S7-12-22, Securities and Exchange Commission, March 28, 2022 ("Proposal"), p. 9.
[2] Proposal, p. 9.
[3] Proposal, footnote 4.
[4] Proposal, pp. 116–119 (emphasis added). "These incentives, or lack of incentives [to remain solvent], create externalities that market forces alone cannot resolve. A market participant who is unable to meet its obligations may harm its creditors, other financial institutions related to its creditors, its trading counterparties, and other participants in securities markets including investors." Proposal, p.117.
[5] Proposal, p. 98.
[6] Proposal, pp. 119–122.

"traditionally performed by entities regulated as dealers," the Proposed Rules instead try to redefine the term "dealer" to encompass customers engaged in a wide range of ordinary investing, trading, arbitrage, hedging, and cash and collateral management.

a. The qualitative prongs of the Proposed Rules will likely scope in large numbers of investors who are not engaged in traditional dealing activity and do not risk imposing negative externalities on other market participants. Regardless, these investors may trigger the qualitative prongs in the course of their ordinary investing, hedging, arbitrage, or cash and collateral management activities.
b. Neither the qualitative nor the quantitative prongs appear designed to focus the dealer registration requirement on the types of entities or the types of trading strategies that the Commission claims could risk imposing negative externalities on other market participants, either through excessive leverage, operational risks, or the potential for market manipulation and fraud.
c. The quantitative prong is completely detached from any requirement that a market participant even be a liquidity provider or engage in activities historically understood by the Commission and the courts as "dealing" activity. It is based only on trading volume. It also appears to be completely unrelated to whether the entity is exposed to relevant "financial and operational risks."

4. In addition to the disconnect between the Commission's intended targets and those likely affected by the new rules, the Proposal's economic analysis does not justify rulemaking. Rigorous economic analysis is a crucial part of the rulemaking process. A proper economic analysis helps ensure that the Commission and the public have a clear understanding of what problem a rule is meant to address, how the rule addresses the problem, whether the rule addresses the problem in the most efficient way, whether the benefits of the rule justify the costs, and what unintended consequences the rule might have.

5. The economic analysis presented in the Proposal is deficient in many respects. First, the justification given for the new rules is not compelling. The Commission provides no evidence that market participants are not sufficiently incentivized to remain solvent and profitable,[7] and essentially asserts that market failures in the form of "negative externalities" due to financial and

[7] Proposal p. 117.

operational risks could exist without any evidence that these negative externalities are real, let alone enough to justify new rulemaking. The Commission also does not provide data, analysis, or other evidence demonstrating that the types of market participants the new rules would target risk presenting purported negative externalities in any significant way. The Proposal cites to a few anecdotes, but these anecdotes do not demonstrate the type of risks that the Proposal is purportedly addressing. Likewise, the Commission justifies the new rules by suggesting dealer registration will deter fraud and manipulation. However, the SEC fails to present any evidence that dealer-specific regulatory requirements will contribute to this goal, particularly in light of the fact that Proposal will impose significant burdens on many participants that are already subject to a robust regulatory framework under the Investment Advisers Act of 1940.

6. Second, the Commission fails to demonstrate that the Proposed Rules address the claimed negative externalities. For example, the Commission does not evaluate whether or how the net capital rule would lower the amounts of leveraged used by affected entities. Nor does it provide evidence that the operational risk controls required under the broker-dealer regulatory framework would limit these externalities. Nor does it describe how trade reporting and incremental changes to examinations and books and records requirements would increase the ability to detect market manipulation and fraud, particularly since many of the impacted entities already have their trades reported (by virtue of transacting with registered broker-dealers and are subject to the Investment Advisers Act of 1940).

7. Third, the Proposal's economic analysis fails to evaluate the extent to which the purported risk of negative externalities resulting from leverage, operational risks, and the potential for market manipulation and fraud are already addressed by the existing regulatory regime. In evaluating whether new rulemaking is necessary, it is not enough to articulate possible problems that could exist in an unregulated world—it is necessary to consider the extent to which a problem still exists given the current regulatory framework. The Proposal does not consider the array of regulatory structures already in place that is designed to deal with possible negative externalities arising from leverage, operational risks, and the potential for market manipulation and fraud.

8. Fourth, the Commission fails to properly consider reasonable alternatives. For example, it does not explain why concerns about leverage, operational risks, and the potential for market

manipulation and fraud could not be addressed with less burdensome changes within the existing regulatory framework. Leverage and operational risks are already addressed by the existing regulatory regime and could be further adjusted within the existing regulatory framework before implementing potentially burdensome new rulemaking. While we believe that the purported benefits of additional trade reporting described in the Proposal are exaggerated, if more trade reporting is needed in specific segments of the fixed income markets, requiring registration is an inefficient way to achieve this objective.[8] At a minimum, the Commission should consider whether more targeted rulemaking that requires additional reporting for specific asset classes would be sufficient.

9. Fifth, the Commission fails to consider the significant unintended consequences of the Proposed Rules. For example, the Commission does not consider that dealer registration would prohibit affected market participants from access to IPOs and cause them to lose various customer protections. More broadly, over expansive dealer registration requirements might have detrimental effects on liquidity. Given that the Commission claims that market participants who are not registered as dealers are "critical sources of liquidity in the U.S. Treasury market,"[9] they should at least evaluate the impact on liquidity of any proposed regulation targeting these market participants. It is unrealistic to assume that current participation levels will be unaffected by expanded dealer registration requirements.

10. In sum, the economic analysis has not provided evidence that the purported risks of negative externalities are likely or real, nor whether they are addressed by the existing regulatory framework, or that the Proposed Rules would address them. Thus, it is not clear what, if any, economic benefits the Proposed Rules would have, much less that the benefits could be large enough to justify the costs.

[8] See, Brain, Doug, et al., "Unlocking the Treasury Market through TRACE," Board of Governors of the Federal Reserve, September 28, 2018, available at https://www.federalreserve.gov/econres/notes/feds-notes/unlocking-the-treasury-market-through-trace-20180928.htm. Since "most domestic Treasury market activity is likely reported into TRACE," incremental reporting for US Treasuries through dealer registration only appears to entail identifying counterparties that are currently anonymous. See also, Section III.A.3 below.

[9] Proposal, p. 7.

II. The Proposed Rules Do Not Appear to be Limited to Those Acting as De Facto Market Makers but Potentially Scopes in a Wide Range of Ordinary Investing, Hedging, Arbitrage, or Cash and Collateral Management Activities.

A. The Proposed Qualitative Prongs Are Poorly Defined and May Be Very Broad in Scope

11. The Commission claims that the qualitative prongs are designed to target participants who assume "dealer-like roles." In doing so, the Commission breaks with decades of historical precedent with a new theory that: dealers provide liquidity; other market participants provide liquidity; therefore, other market participants are dealers.

12. The Proposal defines three qualitative prongs, any one of which could trigger a requirement for a trader to register as a dealer. The language of the proposed qualitative prongs is as follows:

> A person would be engaged in buying and selling securities for its own account "as a part of a regular business" and so a dealer or a government securities dealer, if that person engages in a routine pattern of buying and selling securities that has the effect of providing liquidity to other market participants by:
>
> (i) Routinely making roughly comparable purchases and sales of the same or substantially similar securities in a day; or
>
> (ii) Routinely expressing trading interests that are at or near the best available prices on both sides of the market and that are communicated and represented in a way that makes them accessible to other market participants; or
>
> (iii) Earning revenue primarily from capturing bid-ask spreads, by buying at the bid and selling at the offer, or from capturing any incentives offered by trading venues to liquidity supplying trading interests[10]

13. As an initial matter, the text above could imply that the Commission views satisfying any one of the three prongs of the qualitative test as inherently "having the effect of providing liquidity" regardless of how the trades are executed. In the preamble to these prongs, the Proposal claims that "[t]he liquidity-providing activity captured by the Proposed Rules would

[10] Proposal, p. 42.

include not only passive liquidity-providing activity but also aggressive trading strategies, including or structural trading."[11] This claim is expanded in the footnote which reads:

> "Market participants of the kind that this release addresses, including PTFs, may carry out passive market making strategies. They may also engage in a range of trading strategies that involve submitting aggressive orders, or a combination of passive and aggressive orders, "sometimes rapidly demanding liquidity, in order to quickly liquidate positions accumulated through providing liquidity."
>
> These passive and aggressive strategies are often referred to as "liquidity providing" and "liquidity demanding" or "liquidity taking" strategies respectively. See, e.g., Algorithmic Trading Staff Report. Under the Proposed Rules, both passive and aggressive trading strategies would be considered forms of liquidity provision.

14. It would not make sense to include liquidity-taking orders under the Proposed Rules because by definition, they do not "have the effect of providing liquidity to other market participants." For example, if an investor routinely makes "roughly comparable purchases and sales of the same or substantially similar securities in a day" but always does so using market and marketable limit orders, such an investor would be routinely taking liquidity from the market, rather than providing liquidity. Thus, a market participant can engage in trading that satisfies qualitative prong (i) but in a way that clearly does not have the effect of providing liquidity to other market participants.

15. To see how the qualitative prongs break with prior rulemaking, compare the language proposed for qualitative prongs (i) and (ii) to the language the SEC has used when describing "bona-fide market making" in connection with Rule 203(b)(2), the exception to the locate requirement in Reg SHO. In 2008, the SEC provided the following guidance as to whether a short sale effected by a market maker is done in connection with "bona-fide market making:"

> A pattern of trading that ***includes both purchases and sales in roughly comparable amounts to provide liquidity*** to customers or other broker-dealers would generally be an indication that a market maker is engaged in bona-fide market making activity. Thus, even selling short into a declining market may be an indication that a market maker is engaged in bona-fide market making activity. ***Continuous quotations that are at or near the market on both sides and that are***

[11] Proposal, p. 45.

> ***communicated and represented in a way that makes them widely accessible to investors and other broker-dealers*** are also an indication that a market maker is engaged in bona-fide market making activity. However, as noted above, a market maker must hold itself out as being willing to buy and sell a security for its own account on a regular or continuous basis. Thus, a market maker's quotes must be generally accessible to the public for a market maker to be considered as holding itself out as being willing to buy and sell a security for its own account on a regular or continuous basis, and therefore, to be engaged in bona-fide market making activity.[12] [emphasis added]

It is important to note that this guidance was provided in the context of trades executed by market makers, who are already registered broker-dealers, and who may be seeking to claim an exception to the locate requirement. This guidance does not imply that all market participants who provide liquidity and who purchase and sell in roughly comparable amounts are performing the same economic function as market makers.

16. To start with, Rule 203(b)(2)'s concept of "bona-fide market making" pertains to "quotations" or "quotes." In other words, market making involves providing liquidity through passive orders. Rule 203(b)(2) does not consider aggressive or marketable orders as having the effect of providing liquidity to other market participants. Note that this does not mean that market makers do not use aggressive orders, merely that their liquidity providing function is performed with passive orders.

17. Comparing qualitative prong (i) and (ii) to the language in Rule 203(b)(2), it appears that prong (i) models itself after the first highlighted passage above while prong (ii) has some similarities with the second highlighted portion. However, there are important differences that appear to expand the scope of covered activity. First, the Commission's use of the term "routine" is seemingly far more expansive than the guidance on which it is based. Second, "trading interests" replaces "quotations." As explained above, "quotations" would not generally be understood to encompass marketable orders. If "trading interests" includes marketable orders, this would be a significant departure from what it means to provide liquidity. Finally, it is unclear why prong (ii) does not include similar phrasing to prong (i) as it relates to "same or substantially similar securities." Taken as a whole, the qualitative prongs lack precision, which

[12] "Amendments to Regulation SHO," Release No. 34-58775; File No. S7-19-07, Securities and Exchange Commission, October 17, 2008.

ultimately creates regulatory uncertainty that risks chilling otherwise routine non-dealing market activity given the significant compliance ambiguity.

18. The remainder of Section II is organized as follows. Section 1 explains how, even if the qualitative prongs are confined to liquidity providing orders, the Proposed Rules are overbroad because they fail to account for the fundamental differences between providing liquidity as a dealer and providing liquidity as a trader.[13] As a result, the Proposed Rules likely scope in other types of market participants that might provide liquidity to the market in ways that bear little resemblance to a role that has "traditionally been performed by entities regulated as dealers." Depending on how the different prongs are ultimately interpreted under the Proposed Rules, many investors who routinely execute trades using liquidity providing orders could be deemed to be "having the effect of providing liquidity to other market participants," and thus classified as dealers.

19. Sections 2 to 4 provide a non-exhaustive list of examples of ordinary investment strategies that involve buying and selling the same or substantially similar securities on the same day. These activities would be redefined as activity that would require dealer registration if done often enough to be categorized as "routine" and in a way that "has the effect of providing liquidity to other market participants."[14] However, the motivation for engaging in activities is not to facilitate trading for other market participants, nor to act as an intermediary, nor to perform any other function traditionally associated with acting as a dealer. Some of these activities are investment, trading, and arbitrage strategies employed by investors or investment managers who are merely seeking to identify profitable trading opportunities—for example, by trying to predict future movements in stock prices or by identifying situations where one security appears to be undervalued relative to another. Section 2 describes how funds and separately management accounts can purchase and sell the same security on the same day due to engaging in multiple strategies at the same time. Section 3 describes activities that involve purchasing one security and selling a "substantially similar" security on the same day, such as relative value or arbitrage

[13] The Proposal at least appears to acknowledge this difference: "Section 3(a)(5) of the Exchange Act defines the term 'dealer' to mean 'any person engaged in the business of buying and selling securities . . . for such person's own account through a broker or otherwise,' but excludes 'a person that buys or sells securities … for such person's own account, either individually or in a fiduciary capacity, but not as a part of a regular business.' This statutory exclusion from the definition of 'dealer' is often referred to as the 'trader' exception. As one commentator has described it, at the core of the 'dealer/trader' distinction is an attempt to draw a line between a dealer and 'an ordinary investor who buys and sells for his own account with some frequency.'" See, Proposal, p. 15.

[14] Proposal, p. 42.

strategies. Section 4 describes activities that involve purchasing and selling the same security on the same day.

20. Section 5 describes the types of investors who might be engaged in the various investment, trading, and arbitrage strategies encompassed by one of the three qualitative prongs and thus swept up by the new rules.

1. The Proposal is Overbroad and Fails to Distinguish Dealing Activity from Ordinary Investment Activity

21. The Proposed Rules would require a person to register as a dealer if they trigger any of the qualitative prongs, which would mean their activities "ha[ve] the effect of providing liquidity to other market participants."[15] As noted above, if prong (i) is read to include aggressive orders, then it would wrongly sweep in orders that are demonstrably taking liquidity rather than providing it. However, even confining prong (i) to liquidity providing orders, the Proposed Rules are overbroad because they fail to account for the fundamental differences between providing liquidity as a dealer and providing liquidity as a trader.[16] One of the primary economic roles of dealers is to act as financial intermediaries, by standing willing to take on inventory positions to accommodate the trading needs of their customers or other market participants. As intermediaries, they help facilitate the matching of buyers and sellers when natural counterparties are not readily available in the market, resulting in them taking risky positions that they would otherwise have no interest in taking on. The bid-ask spread compensates dealers for taking on these risks and for other costs associated with acting as an intermediary.[17]

22. In contrast, traders can "provide liquidity" as an incidental side effect of implementing a trading strategy. Traders are often interested in taking a position (or changing a position) in a security or group of securities in order to implement a trading strategy they think is likely to be profitable. They trade to achieve their own objectives—their purpose is not to act as an intermediary or to accommodate the trading needs of others.[18] Traders can generally lower their

[15] Proposal, p. 53.
[16] See footnote 13.
[17] See e.g., Madhavan, Ananth, "Market microstructure: A survey," Journal of Financial Markets 3 (2000) 205–258.
[18] Note that the Proposal does not appear to consider the purpose of trading: "Importantly, under the Proposed Rules, a person's intent is irrelevant; the Proposed Rules focus on the 'effect' of a person's activity, and where a person's activity 'has the effect of providing liquidity,' whether or not that effect is intended, the person would fall within the scope of the Proposed Rules." Proposal, FN 131.

transaction costs by executing their trades in a passive manner—for example using non-marketable limit orders. Non-marketable limit orders may provide liquidity to their counterparties but that does not mean the trader entering them is a "liquidity provider." A trader could buy or sell securities in a way that provides liquidity to other market participants, but that trader's overall trading may bear no resemblance to roles that have "traditionally been performed by entities regulated as dealers."[19]

23. For example, any non-marketable limit order that is placed in an exchange's limit order book and then subsequently executed against an incoming market order is said to be "providing liquidity" to the incoming orders. Similarly, mid-point cross orders routed to an ATS or an exchange often have the effect of "providing liquidity" to other market participants (e.g. if they cannot be executed immediately, but have to wait until another order arrives on the other side of the market).

24. Buy-side algorithms used by brokers to execute equity or fixed income trades on behalf of institutional investors on exchanges or ATSs often incorporate non-marketable limit orders and mid-point cross orders to minimize price impact and lower execution costs. Thus, virtually any type of institutional investor could potentially be said to buy and sell securities in a way that has the effect of "providing liquidity" to other market participants. Moreover, if they trade frequently, they could be characterized as "providing liquidity" to other market participants on a routine basis. This does not mean that they are acting as "liquidity providers" or "*de facto* market makers," or that they are performing an economic role "traditionally performed by entities regulated as dealers."[20] In addition to registered investment companies (which are exempted under the Proposed Rules), this would include entities that have not been exempted by the new rules such as private funds and other categories of institutional investors (e.g., pension plans, insurance companies, university endowments, and municipalities).

25. The term "providing liquidity" may also describe value investors who opportunistically buy securities to take advantage of demand for short-term liquidity. For example, if a seller needs to sell a large quantity of bonds quickly, and where insufficient liquidity is available in the market, a broker facilitating the sale may reach out to institutional investors seeking to find somebody willing to buy at discounted prices. These investors are not "holding [themselves]

[19] Proposal, p. 3.
[20] Proposal, p. 3.

out" as liquidity providers, as dealers would, but may be available to "provide liquidity" when their broker reaches out to them with opportunities. If they "provide liquidity" in such a manner sufficiently frequently, their activity could potentially be considered "routine" under the Proposed Rules.[21] These investors could be private funds, but also could include most other types of institutional or large individual investors.

26. Virtually any type of investor can be described as "providing liquidity" and may be viewed as doing so routinely. Examples include trading with limit orders or mid-point cross orders, or responding to calls from a broker. The question then becomes whether the investor is acting in a way that triggers any one of the three qualitative prongs of the Proposed Rules. As described above, if prong (i) is read to include aggressive orders, then it would wrongly sweep in orders that are demonstrably taking liquidity rather than providing it. However, even confining prong (i) to liquidity providing orders, the following sections describe how the first qualitative prong potentially scopes in a wide variety of investment, trading, and arbitrage strategies.

2. Funds & SMAs

27. Funds and separately managed accounts ("SMAs") often follow multiple different investment, trading, and arbitrage strategies in parallel. These different strategies may be overseen by different portfolio managers, who may be unaware of what securities the other portfolio managers are trading. In this context, one portfolio manager may purchase a security and another portfolio manager may sell the same security (or a substantially similar security) on the same day. For example, a fund could have a long-short strategy that buys a particular stock as part of its "alpha" model, while a convertible bond arbitrage strategy is shorting the same security to delta-hedge its exposure to the equity risk attributable to the long convertible position. Funds and SMAs engage in a similar practice of allocating parts of the portfolio to different portfolio managers, leading to the same problem that one portfolio manager may buy and another portfolio manager may sell the same security.

28. In situations where different portfolio managers may be executing offsetting trades in a manner that "has the effect of providing liquidity to other market participants,"[22] it is not clear

[21] The Proposal's definition of routine is vague and difficult to interpret as an economist: "more frequent than occasional but not necessarily continuous." Proposal, p. 47.
[22] Proposal, p. 53.

how regulators, (including future SEC enforcement staff) might choose to interpret "routine." It is important to note that when a fund's trades are reported to the consolidated audit trail or to TRACE, there is no differentiating between strategies.

3. Arbitrage Trading Strategies

29. Investors often seek to identify situations where the same or similar securities are mispriced relative to each other. For example, if two different securities (or combinations of securities) represent claims on the same or similar cash flows, one would expect the prices of the two securities to be correlated. If one of the assets appears to be underpriced relative to the other, an investor can attempt to profit by purchasing the underpriced asset and selling the overpriced asset. These are sometimes called "relative value" trades, because the investor is taking offsetting positions in two securities based on a view that the two securities are mispriced relative to each other. In situations where the two assets are perfectly or very highly correlated, these trades are also known as "arbitrage" trades. As a simple example, if an asset trades simultaneously on two different trading venues, it should have the same price on both venues. If not, the investor can simultaneously buy where it is cheaper and sell where it is more expensive. The motivation is to profit from the relative mispricing of the asset on different markets. The trigger for deciding to undertake this type of trading strategy is that the investor observes a discrepancy between prices on different markets that presents an attractive trading opportunity.

30. Investors engaging in relative value or arbitrage strategies generally are not acting as market makers—they are not holding themselves out as standing ready to provide liquidity to accommodate the trading demands of other market participants. However, the investor may routinely seek to execute trades using non-marketable limit orders for one or both legs of arbitrage trades to lower transaction costs. If so, their trading pattern may have the effect of providing liquidity to other market participants, and they could be scoped into registration under qualitative prong (i).

31. As described below, there are numerous types of strategies that could potentially trigger qualitative prong (i). While the Commission cites a few examples of activity that would not qualify, the examples we provide are not specifically mentioned in the Proposal.

a) Basis trades

32. There are a variety of "basis trades" that seek to profit from divergences in relative pricing for different products that are expected to revert over time. The Treasury basis trade involves pairing a position in futures with an opposite position in the underlying deliverable note or bond, for example, buying a 10-year Treasury Bond and selling a 10-year Treasury Future. Another similar trade is the swap basis trade. Usually, the rates in interest rate swaps are higher than those for US Treasuries and that difference is referred to as the "swap spread" or "swap basis." Some funds may buy and sell the swap "basis" daily. The Proposed Rules could inadvertently capture this type of trading strategy because the fund would be buying and selling Treasuries. Additionally, swap spreads can turn negative in times of market stress and investors may take positions to represent the view that the swap basis will revert over time. These transactions in the Treasury market would cause investors implementing this strategy to be classified as dealers under the Proposed Rules.

b) Index arbitrage

33. Index arbitrage involves taking offsetting positions in assets or portfolios of assets that are linked to the same index—for example, buying exposure to the index through one or more instruments and selling exposure to the same index through one or more other instruments, to profit from discrepancies in prices. The activities of index arbitrageurs promote market efficiency by helping ensure that the prices of different instruments linked to the same index are correctly priced in relation to each other.

34. To illustrate, securities linked to the S&P 500 index include traditional open-ended mutual funds, exchange-traded funds (ETF), inverse ETFs, leveraged ETFs, Exchange Traded Notes, Structured Products, cash-settled index call and put options, and physically settled call and put options on ETFs. Of course, traders can also buy or sell the index by trading the portfolio of 500 stocks making up the index or a highly correlated subset.

35. Different instruments linked to the same index could be considered "substantially similar" to each other, so that any index arbitrage strategy that involves taking a long position in one security linked to an index and at the same time (or any time on the same day) taking an

offsetting position in another security linked to the same index could trigger the language of prong (i).

36. In addition to the securities mentioned above, there are also futures contracts linked to stock indices that are traded on futures exchanges and regulated by the CFTC. Given that the language of prong (i) specifically refers to purchases and sales of "securities," it is not clear whether an arbitrage trade of a security against a future would in itself trigger the language of the rules. But even if it does not, market participants who engage in arbitrage across the stock and futures markets can still be scoped into prong (i). Index arbitrage involves not only putting on the initial arbitrage trade but also subsequently unwinding it after the prices have converged. Index arbitrage using securities against futures can be done at intraday horizons—arbitrageurs may trade on short-term discrepancies between ETFs and futures by putting on an arbitrage trade and then unwinding it later the same day. This would involve two offsetting trades in the same securities on the same day, and may trigger the language of prong (i). This problem is exacerbated if the arbitrageur makes a number of similar trades on the same day.

c) Convertible Bond Arbitrage

37. The language of prong (i) refers to purchases and sales on the same day of "substantially similar" securities. While the Proposal gives some guidance and examples as to what might or might not be considered "substantially similar," it is not clear precisely how certain well-known types of trading strategies (commonly conducted by hedge funds and other kinds of investors) might be treated.

38. Convertible bonds are bonds that can be converted into the issuer's stock at a defined price. The conversion feature of a convertible bond makes it economically similar to a bond combined with an option. When the market moves in a direction that makes converting the bond attractive (i.e., the option is "in the money"), the prices of the convertible bonds increasingly behave more like the underlying equity price, moving up and down in sync with the underlying stock price.

39. Convertible bond arbitrage is a strategy in which an investor purchases convertible bonds and establishes a hedge position by short selling the underlying stock, seeking to profit from a situation where the bonds are believed to be undervalued. As explained in one of my research

publications, "Hedge funds are not restricted by the provisions of the Investment Companies Act of 1940 that relate to short sales. In convertible arbitrage, hedge funds' typical buy-and-hedge strategy is to buy convertibles and to short the stock of the issuing firm with the short position being determined by the convertible's delta."[23]

40. While the Proposal suggests[24] that the Commission does not believe that stocks and bonds issued by the same company would be "substantially similar," it is not obvious whether this interpretation would extend to in-the-money convertible bonds, which tend to behave more like stocks, and come much closer than ordinary bonds to satisfying the factors the Proposal outlines.[25]

41. Under the Proposed Rules, if convertible bonds are considered "substantially similar" to the stock, then an investor who engages in convertible bond arbitrage could trigger prong (i) if they hedge by short selling on the same day that they purchased the convertible bonds.

d) Merger Arbitrage

42. Merger arbitrage, also known as "risk arbitrage" is another common trading strategy. It involves purchasing shares of a company that has been announced as the target of an acquisition, seeking to profit by capturing the discount in the price of the target stock that exists after the merger is announced but before the merger is consummated. In a stock-for-stock merger deal, merger arbitrage involves purchasing the target firm and short selling the stock of the acquiring firm.

43. The Proposal suggests that it would not consider another stock in the same industry as an example of a "substantially similar" security that would trigger prong (i).[26] However, after an announcement of a pending acquisition in a stock deal, the price of the target firm should begin to be more correlated, or to move more in tandem with the price of the acquiring firm. Thus, it is not clear whether the SEC will ultimately interpret the stock of a target firm to be "substantially

[23] See, e.g., Stephen J. Brown, Bruce D. Grundy, Craig M. Lewis, and Patrick Verwijmeren, "Convertibles and Hedge Funds as Distributors of Equity Exposure," The Review of Financial Studies 25(10), 2012, pp. 3077–3112.
[24] Proposal, p. 52.
[25] Specifically, the Proposal suggests that one factor for consideration is whether "changes in the fair market value of one security are reasonably expected to approximate, directly or inversely, or a fraction or a multiple of, the fair market value of the second security." See, Proposal, p. 51. Convertible bond prices are correlated with the stock price, and it is possible to estimate the "delta" or the amount it is expected to move when the stock price moves.
[26] Proposal, pp. 51–52.

similar" to that of the acquiring firm in the period between the announcement and consummation of the merger. If it does, then a fund engaging in merger arbitrage could potentially trigger prong (i) if it sells the acquiring firm short on the same day that it purchases shares of the target firm.

e) Option Market Arbitrage/Hedging

44. There are numerous arbitrage trading strategies involving combinations of different options, or combinations of stock and options, designed to take advantage of situations where there is relative mispricing.

45. For example, combinations of stock and options can be used to take advantage of mispricing situations where option prices are too high or too low (e.g., violate certain "upper bound" and "lower bound" conditions). Option spread strategies may be used to take advantage of mispricing where the difference between options with different strike prices is too large or too small. These involve buying and selling options of the same type (both calls or both puts) but with different strike prices. Calendar spread strategies may be used to take advantage of relative mispricing of shorter-term versus longer-term options. Conversion or reverse conversion strategies may be used to take advantage of relative mispricing between a stock, call option, and put option (e.g., if the prices deviate from a theoretical relation known as put-call parity).[27] These types of strategies are widely utilized among funds that trade options.[28]

46. Certain stock and option strategies also involve continuously trading the stock, which could also trigger the qualitative prong. Consider a simple long call position that is being delta hedged. When the stock price falls, the trader would sell some of their stock (delta decreases) and when the stock price rises, they would buy back some stock (delta increases). Such a strategy attempts to profit from the volatility of the stock.

[27] See, e.g., Hull, John, "Options, Futures, and Other Derivatives," edited by Donna Battista, Erin McDonagh, Elissa Senra Sargent, and Jeff Holcomb (2009), p. 834; Mayhew, Stewart, "Option Strategies," Financial Derivatives: Pricing and Risk Management, edited by Robert Kolb and James Overdahl (2009), p. 509–510.

[28] Hull, John, "Trading Strategies Involving Options," Options, Futures, and Other Derivatives (2009), pp. 254–273; Mayhew, Stewart, "Option Strategies," Financial Derivatives: Pricing and Risk Management, edited by Robert Kolb and James Overdahl (2009), p. 511.

47. Given that the "substantially similar" language in the Proposed Rules likely applies to stock and options, presumably any trader routinely engaging in arbitrage strategies in option markets could trigger prong (i) and be required to register as a dealer.

4. Intraday Trading Strategies

48. A number of intraday directional trading strategies that execute with limit orders (which are generally understood to provide liquidity) would be captured by the Rules' qualitative prongs. These could include:

a. An investor that purchases a security in the morning and sells it later in the day, based on a technical model that attempts to predict intraday price movements.
b. An investor that believes the market systematically tends to overreact to a particular type of news announcement will trade in the opposite direction of the announcement with intention of taking an offsetting position when the price reverts to its anticipated level.
c. An investor that wishes to take a directional position immediately prior to a scheduled news announcement (e.g., expressing a view on whether the news will be good or bad) and exit the position later in the day after the market reacts to the news.

Even though limit orders provide liquidity to other market participants, traders engaged in these types of strategies would not generally be considered to be taking on a role that has "traditionally been performed by entities regulated as dealers." Here, the impetus for taking on a position using limit orders is not related to acting as an intermediary or accommodating the liquidity needs of other investors, but taking advantage of trading opportunities perceived to be profitable.

5. Types of Investors Affected

49. The various strategies described above are followed by different types of investors. The Proposal seeks to justify itself with a discussion of the rise of proprietary trading firms (PTFs), describing them as "businesses that often employ automatic, algorithmic trading strategies."[29]

[29] Proposal, p. 6.

The Proposal states "the Commission's analysis indicates that the Proposed Rules would primarily require registration by PTFs, and potentially some private funds."[30]

50. As discussed above, the qualitative prongs, interpreted broadly, potentially scope in a wide variety of trading strategies including intraday directional trading, numerous types of arbitrage strategies, and other types of strategies that may involve hedging. Virtually any of these strategies can be interpreted to "have the effect of providing liquidity to other market participants."[31] The Proposal is ambiguous as to how to differentiate between "occasional" and "routine," which is problematic because effectively pursuing these types of strategies often requires one to trade frequently, even multiple times during the course of a given trading day.

51. While the Proposal attempts to justify the Proposed Rules by identifying PTFs as "liquidity providers," some of the activities described above are common not only to PTFs but also to many private funds, even though private funds may have "alpha" models that are structured to earn returns in excess of a benchmark and do not intentionally derive profits from the bid-ask spread. Merger arbitrage and convertible bond arbitrage are known to be common hedge fund strategies, as is fixed income arbitrage. Other institutional investors that are not classified as hedge funds may also follow some of these strategies, as could pension plans, insurance companies, university endowments, municipalities. The qualitative prongs might also scope in investment advisers managing over $50 million in separately managed accounts and smaller PTFs or individuals with assets of over $50 million, many of whom may be engaged in intraday trading.

52. However, the Proposal presents an incomplete analysis of how the qualitative prongs might affect private funds or other types of investors. For investors trading Treasuries, the Proposal appears to conclude that the qualitative prongs would have little to no effect on hedge funds and other firm types.[32] This analysis does not appear to consider the institutional structure of the Treasury market:

a. The Proposal's analysis considers a simplistic quantitative measure of "buy-sell volume imbalance" as a proxy for qualitative prong (i) for the highest volume

[30] Proposal, p. 12.
[31] Proposal, p. 42.
[32] Proposal, Table 3.

Treasury security in July 2021. It finds just 29 hedge funds that were identified in the FINRA data.[33]

b. By considering only a single security, the analysis ignores that prong (i) covers "substantially similar securities" which includes "selling a Treasury security and buying another Treasury security in the same maturity range."[34] Thus, the analysis is incomplete.

c. The 29 hedge funds identified because they traded on ATSs that are required to report counterparty identity information (i.e., those covered by FINRA Rule 6730.07)[35] are likely not representative of all the entities that appear anonymously in TRACE data. There are two main segments to the Treasury market: the interdealer segment and the dealer-to-client (DTC) segment.[36] If the ATSs that report counterparty identity information are operating in the interdealer segment, without further analysis it is unlikely their data would be representative of the DTC segment.[37] In other words, the Proposal's extrapolation from their limited data is inappropriate and very likely understates the number of persons affected by the Proposal.

53. For investors trading equities, the Proposal appears to conclude that the qualitative prongs would affect just 41 to 61 "CAT FDID institutional customer accounts."[38] This analysis is also superficial: it considers the same "buy-sell imbalance" measure, only for one ticker (SPY) in October 2021, and is not able to distinguish between different types of investors.

54. While the Proposal admits various caveats to its purported analysis, it claims that "[d]espite these caveats, we believe that the results… provide useful indications about the scope

[33] The number of other firm types is suppressed in Table 3 but at least 1 firm is represented in the data.
[34] Proposal, p. 52.
[35] Proposal, footnote 217.
[36] "IDBs historically have intermediated trades between dealers. However, after IDBs introduced electronic trading platforms, they also eventually opened up to firms beyond the traditional bank and dealer community, notably PTFs which specialize in electronic and automated intermediation. The DTC space has evolved as well, with request-for-quote (RFQ) platforms enabling clients to solicit bids and offers from multiple dealers electronically. More recently, some PTFs have begun offering direct stream services to dealers, which feature live, continuous, executable prices, delivered electronically under bilaterally negotiated terms." See, Brain, Doug, et al., "Unlocking the Treasury Market through TRACE," Board of Governors of the Federal Reserve, September 28, 2018, available at https://www.federalreserve.gov/econres/notes/feds-notes/unlocking-the-treasury-market-through-trace-20180928.htm.
[37] "In the DTC segment, dealers make markets in Treasuries upon request from clients, which include foreign central banks, mutual funds, hedge funds, pension funds, insurance companies and corporations." See, Brain, Doug, et al., "Unlocking the Treasury Market through TRACE," Board of Governors of the Federal Reserve, September 28, 2018, available at https://www.federalreserve.gov/econres/notes/feds-notes/unlocking-the-treasury-market-through-trace-20180928.htm.
[38] Proposal, pp. 115–116, Table 4.

of the Proposed Rules in the markets for U.S. Treasury securities and NMS stocks."[39] Given how broadly the three qualitative prongs could be interpreted (as demonstrated above), and how limited the Proposal's analysis is, the Commission has not presented sufficient evidence to support the "indication" that only a few private funds or other types of investors would be affected.

B. The Proposed Quantitative Prong Is Poorly Defined and Is Very Likely Too Broad in Scope

55. In addition to the three qualitative prongs discussed above, the Proposal would establish a "bright-line test" to include as a dealer[40] anybody who has more than "$25 billion of trading volume in government securities… in each of four out of the last six calendar months." [41] However, there are at least five limitations to this "bright-line test:" 1) it is not linked to "providing liquidity" (the Commission's stated focus), 2) the data used to establish the threshold are inadequate, 3) it does not consider the overall size or institutional trading patterns in the U.S. Treasury market, 4) it does not clarify how the threshold would be implemented, and 5) it does not consider a potential unintended impact on participation in the US Treasury market as funds diminish or cease trading activities as they approach the bright line threshold.

56. First, the quantitative prong is unrelated to any of the characteristics that the Proposal has identified as indicia of dealer activity, such as providing liquidity in the form of two-sided quotes to other market participants. This is problematic because it can be independently triggered regardless of whether any of the qualitative prongs are satisfied. Thus, the quantitative prong does not appear to capture the types of market participants that the Proposal claims to be targeting.

57. Second, while the Commission states that "the proposed trading volume threshold was derived from analysis of historical U.S. Treasury Securities transactions reported to TRACE,"[42] the analysis relies on incomplete data which the Commission fills in by extrapolation. The Proposal states that the analysis is "limited to the subset of TRACE data where…the individual

[39] Proposal, p. 116.
[40] Proposal, p. 31.
[41] Proposal, pp. 68–69.
[42] Proposal, p. 71.

firms [can be identified]" for trading throughout July 2021.[43] Thus, the analysis only covers 42 percent of the non-FINRA member volume that occurred on "certain ATSs [that contain] the identity of non-FINRA member trading parties." Importantly, this data only represents a subset of market participants (those that trade on ATSs); and only a portion of those market participants total trading volume (i.e., trades executed on ATSs).

58. The Commission's analysis of the quantitative prong suffers from the same flaw as its analysis of the qualitative prong described above: it ignores the institutional structure of the Treasury market. The trades being analyzed, i.e., trades by non-FINRA registered entities with counterparty information, occurred on ATSs that are covered by FINRA Rule 6730.07.[44] If these ATSs are from the interdealer segment of the market, they are not necessarily representative of trades from other segments of the market that would appear anonymously in TRACE. As a result, the Commission does not have any basis to scale from $10 billion in observed trading volume to the $25 billion threshold that the quantitative prong seeks. Furthermore, while the Commission estimates that approximately 46 firms would be affected by the Proposed Rules, since its data is limited only to trades on specific ATSs, the actual number of firms is likely substantially higher. The Commission does not consider whether there could be firms with $25 billion of trading volume who do not trade on ATSs.

59. Third, the Commission's analysis does not consider the overall size of the U.S. government securities market when establishing the $25 billion monthly trading volume threshold nor potential growth in the market. In the first quarter of 2022, the Securities Industry and Financial Markets Association (SIFMA) reports that the average daily trading volume for U.S. Treasuries is approximately $697 billion, which would equate to monthly trading volume of approximately $14.6 trillion.[45] Thus, the proposed $25 billion monthly trading volume threshold would include firms that account for approximately 0.17% of the monthly trading volume in the U.S. Treasuries market. It seems unlikely that individual firms that account for approximately 0.17% of the monthly trading volume in the U.S. Treasuries market would be "market

[43] Proposal, p. 104.
[44] Proposal, footnote 217.
[45] "SIMFA Research Quarterly – 1Q22: US Fixed Income Markets – Issuance & Trading," SIFMA, April 2022. ($697 billion x 21 trading days per month) = $14.6 trillion monthly trading volume.

participants that are providing an important liquidity provision function in today's securities markets."[46]

60. Furthermore, the proposed $25 billion monthly trading volume threshold is inflexible and will ultimately impact a larger number of participants as the market grows. Specifically, as the U.S. government securities market grows, it is reasonable to assume that the monthly trading volume will continue to grow, causing the static $25 billion monthly trading volume threshold to be an even smaller percentage of the overall trading in the market. In fact, the Proposal itself points out that "the amount of U.S. Treasury securities outstanding has increased substantially" from $5.1 trillion in 2007 to $23.1 trillion in 2021, which represents a compound annual growth rate (CAGR) of 11.4%.[47] The Congressional Budget Office forecasts the value of outstanding treasuries to grow to $40.2 trillion by 2032.[48]

61. Fourth, the Proposal does not provide sufficient detail on how the proposed $25 billion trading volume threshold will be measured and implemented. While the Proposal states that the firms "engaged in buying and selling more than $25 billion of trading volume in government securities…in each of four out of the last six calendar months" would be included, it does not discuss whether firms will be required to measure this on a rolling basis, how soon a firm would have to register after meeting the threshold, and how a firm's registration status would be affected if its trading volume dropped below the $25 billion threshold.[49]

62. Fifth, the Proposal has not considered the unintended consequence of a bright line rule, which would deter participation as a firm approaches the $25 billion threshold. This is not merely a theoretical problem.[50]

III. The Economic Analysis in the Proposing Release is Deficient

63. Notwithstanding the disconnect between the Commission's intended targets and the investors who would likely be affected by the Proposed Rules, the Commission has failed to present economic analysis that justifies the proposed rulemaking. The Commission claims that

[46] Proposal, p. 11.
[47] CAGR = ($23.1 trillion/$5.1 trillion)^(1/14 years) – 1 = 11.4%
[48] "The Budget and Economic Outlook: 2022 to 2032," Congressional Budget Office, May 2022, available at https://www.cbo.gov/publication/58147#_idTextAnchor007.
[49] Proposal, pp. 68–69.
[50] See e.g., "Money Market Funds Reform," Proposed Rule by the Securities and Exchange Commission, Federal Register 87, no. 26, 2022, pp. 7248-7356.

new rules are required to address the potential for negative externalities to be imposed by "liquidity providers" on other market participants through excessive leverage, operational risks, and the potential for market manipulation and fraud. This claim is the entire foundation of the economic analysis. However, the Proposal fails to demonstrate that the risk of such negative externalities is actually posed by "liquidity providers" or any of the other types of investors scoped in by the new rules. The Proposal also fails to demonstrate how the proposed dealer registration requirement would be effective in addressing the purported risk of such negative externalities. Finally, the Proposal fails to properly consider reasonable alternatives and potential unintended consequences.

64. Section A below addresses the Proposal's claims regarding the potential for market manipulation and fraud and how they can be addressed through certain aspects of dealer registration, namely trade reporting, examinations, and books and records requirements. This section argues that 1) the Proposal fails to show that the lack of trade reporting, examinations, and books and records requirements imposes negative externalities on other market participants; 2) the Proposal fails to establish any benefits to additional trade reporting; and 3) TRACE reporting could be expanded without dealer registration.

65. Section B addresses the Proposal's claims regarding operational risks and how they can be addressed through dealer registration. This section argues that 1) the Proposal fails to show that operational risks impose negative externalities on other market participants, and 2) the Proposal fails to explain why purported negative externalities due to operational risks are not already addressed by existing regulation or why dealer registration would help.

66. Section C addresses the Proposal's claims regarding leverage and how they can be addressed through net capital requirements imposed on dealers. This Section argues that 1) the Proposal fails to show that excessive leverage imposes negative externalities on other market participants, 2) the Proposal fails to explain why purported negative externalities due to excessive leverage are not already addressed by existing regulation, and 3) the Proposal does not show that the Proposed Rules would reduce leverage.

67. Section D identifies at least three potential unintended consequences of dealer registration that the Proposal has not considered: 1) impact on market liquidity, 2) access to IPOs, and 3) loss of customer protections.

A. Potential for Market Manipulation and Fraud

1. The Proposal Fails to Show That Lack of Reporting Causes Negative Externalities to Other Market Participants.

68. The Proposal describes broad scenarios in which market participants could, in theory, impose negative externalities on the market through undetected market manipulation and fraud. However, it is unclear whether these scenarios are empirically relevant. The Commission does not cite any enforcement actions of market manipulation or fraud that were attributable to any market participant not registered as a dealer who would be required to register under the Proposed Rules.

69. The Proposal claims that market participants who are not registered as dealers could hide fraud and prevent regulators from being able to study the market. In particular,

> The potential for market manipulation or fraud constitutes other negative externalities, since such behavior may distort market prices or give the perpetrator unfair advantages over other market participants….
>
> Private information that market participants who are not registered as dealers do not report to regulators also creates an impediment to regulators' ability to study markets in a structured way, to detect and respond to market events, or to inform investors.[51]

70. While the Proposal claims to be targeting "liquidity providers," these claims about fraud appear to be general concerns that could affect all market participants, rather than a type of risk specific to liquidity providers. Beyond general concerns, the Commission fails to provide any examples of non-dealer participants that meet the Commission's new proposed definition of "dealer" engaging in fraud or manipulation. Nor does it establish any basis for alleging that such persons are likely to commit fraud in the future.

71. The Proposal also does not show how additional dealer registration would reduce market manipulation and fraud. The Proposal claims that:

[51] Proposal, pp. 119–120.

> Several elements of the dealer regulatory regime address these risks, but some important elements do not currently apply to market participants that are not registered as dealers, including financial reporting, examinations, and other regulations that facilitate examinations. Financial statement reporting, transaction reporting (to TRACE or CAT), and examinations help the Commission detect manipulation or fraud and determine whether firms are in compliance with applicable regulations. Books and records requirements facilitate examinations by ensuring that data entries are defined, recorded, and preserved in a consistent man[n]er across all dealers.[52]

However, the Commission does not cite even a single enforcement action of market manipulation or fraud that was hidden because of either incomplete trade reporting, lack of examinations, or books and records failures on behalf of a market participant that was not registered as a dealer. Furthermore, as explained below, CAT already covers essentially all of trading in equities, and TRACE covers all domestic US Treasuries transactions.

2. The Proposal Fails to Establish Any Benefits to Additional Trade Reporting.

72. The Commission claims that lack of reporting is a problem sufficient to justify rulemaking, but the Commission does not quantify the size of this purported regulatory gap. We note that most domestic Treasury market activity is reported to TRACE.[53] Thus, it appears the only incremental changes would be to increase the percentage of transactions in which both counterparties are identified in TRACE reports, as well as to otherwise attempt to capture the small subset of transactions that occur between non-dealers that are not currently reported. The Proposal has not shown that this information justifies such sweeping regulation, and for the reasons described below, any trades between non-dealers that fall within the proposed definition are likely already reported under today's regulatory framework.

73. For equities, the Proposal concedes that all private funds and PTF transactions are already captured in CAT but claims that "certain other information is only available for firms that report directly to CAT."[54] However, a footnote in the Proposal states:

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[52] Proposal, p. 120.

[53] Brain, Doug, et al., "Unlocking the Treasury Market through TRACE," Board of Governors of the Federal Reserve, September 28, 2018, available at https://www.federalreserve.gov/econres/notes/feds-notes/unlocking-the-treasury-market-through-trace-20180928.htm.

[54] Proposal, footnote 245: "CAT also includes the transactions of firms that are not registered as dealers, but certain other information is only available for firms that report directly to CAT."

> Regarding CAT data availability, hedge funds are currently not identifiable because CAT Firm Designated ID ("FDID") numbers do not map to broker-dealers' customers. Starting in July 2022, CAT data will identify broker-dealers' customers, including hedge funds."[55]

Thus, after July 2022, there does not seem to be any additional reporting to CAT that could be achieved through dealer registration.

74. For fixed-income securities, the Proposal claims with respect to TRACE reporting that trades would be missing from TRACE if they occurred between two non-FINRA members who did not use a registered ATS.[56] And while a requirement that these participants register as dealers would bring these trades into TRACE, the Proposal does not demonstrate that any such trading actually exists. To the extent that it does exist, the Proposal does not demonstrate that it would be the type of trading that would require dealer registration under the new rules. If market participants who are not already registered as dealers are providing liquidity on a "routine" basis such that they trigger the qualitative prongs, a natural venue for them to trade on would be an ATS or with a FINRA member, in which case their trades would already be reported to TRACE. If that ATS were covered by FINRA Rule 6730.07, the entities would also be identified in the data.[57] As of 2018, a Federal Reserve Board publication states that "since most major broker-dealers and IDBs are [FINRA] members, most domestic Treasury market activity is likely reported into TRACE."[58] Furthermore, as of January 2022, the Commission has already proposed additional changes to the ATS rules to bring in additional platforms.[59]

75. Indeed, while the Commission cites the October 2014 Treasury market volatility to motivate this Proposal,[60] it does not address the previous regulation it had enacted in the wake of that event. In October 2016, the Commission approved a FINRA proposal to expand TRACE

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[55] Proposal, footnote 228.

[56] Proposal, FN 244: "Registered dealers report their transactions in fixed-income securities (other than municipal bonds) to TRACE. Unregistered traders' fixed-income transactions only appear in TRACE in two cases: (i) when they trade with a FINRA member, the FINRA member reports the transaction to TRACE but keeps the counterparty anonymous; or (ii) when they trade government securities on an ATS that is a FINRA member, the ATS reports the transaction to TRACE along with the identity of the counterparties."

[57] Proposal, footnote 217.

[58] Brain, Doug, et al., "Unlocking the Treasury Market through TRACE," Board of Governors of the Federal Reserve, September 28, 2018, available at https://www.federalreserve.gov/econres/notes/feds-notes/unlocking-the-treasury-market-through-trace-20180928.htm.

[59] "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." Release No. 34-94062; File No. S7-02-22, Securities and Exchange Commission, January 26, 2022.

[60] Proposal, p. 10.

reporting to include Treasuries in response to the October 2014 market volatility.[61] That rule change followed consultations with various agencies including the Treasury and FINRA and went into effect in July 2017.[62] This Proposal has not presented any analysis of why additional trade reporting via dealer registration is now required to address the event from 2014.

3. TRACE Reporting Could Be Expanded Without Dealer Registration.

76. If the Federal Reserve Board publication is correct that "most domestic Treasury market activity is likely reported into TRACE,"[63] then the only potential expansion might be to require already reporting entities to identify counterparties that are currently anonymous.

77. If the Commission determines it is important to expand TRACE reporting, it could do so without dealer registration. While the Proposal briefly considers requiring "private funds or private fund advisers who meet the rule's activity standards to report to TRACE, without requiring them to comply with the other aspects of dealer regulations,"[64] the Proposal dismisses this approach because "this alternative would not require private funds or private fund advisers to comply with net capital requirements, or with the operational risk-management provisions of the dealer regime. Therefore, this alternative would fail to address all of the potential for negative externalities that may stem from market participants' financial stress, as discussed in the baseline."[65]

78. Thus, it appears the Commission is of the view that the primary reason to require dealer registration is to address leverage. As discussed below, the Commission has failed to establish an economic rationale for targeting the leverage of any market participant through dealer registration. If the claimed leverage benefits are illusory, the new rules would appear to be

[61] "Notice of Filing of Amendment No. 1 and Order Granting Accelerated Approval of a Proposed Rule Change, as Modified by Amendment No. 1, Relating to the Reporting of Transactions in U.S. Treasury Securities to TRACE," Release No. 34-79116; File No. SR-FINRA-2017-027, Securities and Exchange Commission, October 18, 2016.
[62] See, e.g., Fleming, Michael, "Advent of Trade Reporting for U.S. Treasury Securities," Liberty Street Economics, January 18, 2017, available at https://libertystreeteconomics.newyorkfed.org/2017/01/advent-of-trade-reporting-for-us-treasury-securities/.
[63] Brain, Doug, et al., "Unlocking the Treasury Market through TRACE," Board of Governors of the Federal Reserve, September 28, 2018, available at https://www.federalreserve.gov/econres/notes/feds-notes/unlocking-the-treasury-market-through-trace-20180928.htm.
[64] Proposal, p. 153.
[65] Proposal, p. 153.

unjustified—the transparency benefits of expanded TRACE reporting could be achieved without registration, at least for private funds and private fund advisers.

B. Operational Risks

1. The Proposal Fails to Show That Operational Risks Impose Negative Externalities on Other Market Participants.

79. The Proposal describes how an operational risk incident could, in theory, impose negative externalities on the market,[66] but does not provide an analysis of such externalities in practice. While the Commission claims to be targeting operational risks at "liquidity providers," the two examples of operational risks it cites do not appear to involve firms that are acting as liquidity providers.

80. The Proposal describes two general "disruptions that can occur from losses related to operational risk:"[67]

> One risk is that a firm may not be able to find offsetting trades, and so accumulates an unexpectedly large position that must be rapidly liquidated at a loss. Another risk is that errors in trading algorithms or other systems (including human errors) lead to an unexpectedly large position that must be rapidly liquidated at a loss. Since, as discussed above, losses on the part of one market participant can harm others, dealer regulations are designed to mitigate the magnitude of these externalities and to reduce the probability that they occur at all.[68]

To start, it is not clear if or how often examples such as these actually cause "negative externalities." If a proprietary trading firm or investor is trading its own capital, an error that requires it to liquidate a large position at a loss would generate losses for itself, not for other market participants, some of whom presumably would profit from acquiring liquidated positions at a discount. While in theory, losses or errors could be so large that they affect market prices and volatility, the Proposal's economic analysis does not evaluate how frequently such events happen, which markets they occur in, or the costs they might impose on other market participants.

[66] Proposal, p. 119.
[67] Proposal, p. 119.
[68] Proposal, p. 119.

81. In the first theoretical scenario where "a firm may not be able to find offsetting trades, and so accumulates an unexpectedly large position,"[69] the Proposal does not clarify how this relates to "liquidity providers" or market making firms. In general, financial economists characterize liquidity providers or market makers as entities that attempt to earn the bid-ask spread while maintaining a flat position.[70] They would not generally aim to accumulate large positions because they are not in the business of taking directional positions, but rather seek to minimize their inventory risk.[71] Thus, the scenario the Proposal describes is inconsistent with how liquidity providers would be expected to trade. However, the Proposal does not provide any specific examples or further details.

82. In the second scenario due to "errors in trading algorithms or other systems" the Proposal provides two examples:

> In 2012, an algorithm error at a single trader temporarily affected the prices of 150 stock tickers, causing some to increase or decrease more than 30 percent versus the day's opening. *See Knight Capital Americas LLC*, Exchange Act Release No. 70694 (Oct. 16, 2013) (settled matter). Another firm, after a change in code and in routing logic, erroneously allowed millions of orders with a notional value of approximately $116 billion to be sent between 2010 and 2014. *Latour Trading LLC*, Exchange Act Release No. 76029 (Sept. 30, 2015) (settled matter).[72]

However, neither of these examples were directly related to liquidity provision, although Knight was a liquidity provider at the time.[73] Furthermore, as discussed in the section below, both of these examples involved registered dealers that were also FINRA members, so it is unclear how dealer registration could prevent similar cases from occurring.

83. For Latour, the error seems attributable to a liquidity-taking algorithm, rather than one providing liquidity. According to the SEC, Latour used high-frequency algorithmic trading to trade securities and ETFs. As part of its strategy, Latour would hedge its positions using aggressive intermarket sweep orders (ISOs,) which allowed it to fill an order at multiple price

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[69] Proposal, p. 119.

[70] See, e.g., Albert S. Kyle, "Continuous Auctions and Insider Trading," Econometrica 53(6), 1985, pp. 1315–1335; or Lawrence R. Glosten, "Insider Trading, Liquidity, and the Role of the Monopolist Specialist," The Journal of Business 62(2), 1985, pp. 211–235.

[71] See, e.g., Joel Hasbrouck and George Sofianos, "The Trades of Market Makers: An Empirical Analysis of NYSE Specialists," The Journal of Finance 48(5), 1993, pp. 1565–1593.

[72] Proposal, p. 119, footnote 243.

[73] BrokerCheck Report Knight Capital Americas, L.P.," FINRA, available at https://files.brokercheck.finra.org/firm/firm_38599.pdf.

points, by filling all available trades at the best quote and the rest of the order at the next best offer.[74] As part of its strategy, Latour's algorithm disregarded the best offer if an ISO order was cancelled or completely filled at the same price point within a fraction of a second. The SEC alleged that this resulted in situations where Latour was not in full compliance with Rule 611, apparently due to an error in the logic of Latour's algorithm.[75] This appears to be a technical compliance issue that potentially resulted in Latour getting a slightly worse execution on some of its own trades. The Proposal does not explain how this destabilized the market or imposed costs on other market participants.

84. For Knight, the error in its trading algorithm seems to have been due to an order router that it offered to its clients rather than part of its market making business. According to the SEC, the Knight incident resulted from an error in its Smart Market Access Routing System ("SMARS") that "received orders from broker-dealers whose customers were eligible to participate in [NYSE's Retail Liquidity Program]."[76] SMARS received "parent" orders from Knight's clients and then split the order into one or more "child" orders which it executed on external venues.[77] Because of an error, the SMARS system did not properly update previously filled child orders, resulting in Knight continuing to place child orders after parent orders submitted by clients were filled. This resulted in Knight inadvertently assuming $3.5 billion in long positions and $3.15 billion in short positions within 45 minutes,[78] resulting in a $460 million loss.[79]

85. The Commission's two motivating examples appear to reflect errors that could happen at any electronic trading firm, rather than a type of risk specific to "liquidity providers." It does not establish that this type of operational risk is more prevalent among private funds and PTFs that are not registered as dealers versus those that are. Given that both Knight and Latour were

[74] "In the Matter of Latour Trading LLC: Order Instituting Cease-And-Desist Proceedings, Pursuant To Section 21C Of The Securities Exchange Act Of 1934, Making Findings, And Imposing Remedial Sanctions And A Cease-And-Desist Order," Exchange Act Release No. 76029, Securities and Exchange Commission, September 30, 2015 ("Securities Exchange Act Release No. 76029"), p. 5.
[75] Securities Exchange Act Release No. 76029, p. 15.
[76] "In the Matter of Knight Capital Americas LLC: Order Instituting Administrative and Cease-and Desist Proceedings, Pursuant to Sections 15(b) and 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order," Exchange Act Release No. 70694, Securities and Exchange Commission, October 16, 2013 ("Securities Exchange Act Release No. 70694"), p. 6.
[77] Securities Exchange Act Release No. 70694, p. 5.
[78] Securities Exchange Act Release No. 70694, p. 6.
[79] Securities Exchange Act Release No. 70694, p. 6.

registered broker-dealers, these examples do not provide evidence of a problem that can be addressed by requiring dealer registration.

2. The Proposal Fails to Explain Why Purported Negative Externalities Due to Operational Risks are not Already Addressed by Existing Regulation or Why Dealer Registration Would Help.

86. The Proposal does not address how existing regulations may already address the examples it presents. All the investors that the Proposed Rules consider would currently access the market through a broker-dealer that is subject to the Exchange Act of 1934. All registered broker-dealers are subject to the SEC's Market Access Rule (Rule 15c3-5) which was explicitly designed to address the type of operational risks the Proposal describes.[80] In situations where trading algorithms are designed by parties that are not themselves broker-dealers, the rule clearly puts the responsibility on the broker-dealer who gives the party access to the market to ensure that adequate risk controls are in place. As the Proposing Release to the Market Access Rule explains:

> Rule 15c3-5 will require brokers or dealers with access to trading securities directly on an exchange or alternative trading system ("ATS"), including those providing sponsored or direct market access to customers or other persons, and broker-dealer operators of an ATS that provide access to trading securities directly on their ATS to a person other than a broker or dealer, to establish, document, and maintain a system of risk management controls and supervisory procedures that, among other things, are reasonably designed to (1) systematically limit the financial exposure of the broker or dealer that could arise as a result of market access, and (2) ensure compliance with all regulatory requirements that are applicable in connection with market access. **The required financial risk management controls and supervisory procedures must be reasonably designed to prevent the entry of orders** that exceed appropriate pre-set credit or capital thresholds, or **that appear to be erroneous**.[81] [emphasis added]

87. In fact, for both the operational risk examples that the Commission provides, Knight and Latour, the SEC found that their problems were caused by violations of the Market Access

[80] "Risk Management Controls for Brokers or Dealers with Market Access," Release No. 34-63241; File No. S7-03-10, Securities and Exchange Commission, November 2, 2010.
[81] "Risk Management Controls for Brokers or Dealers with Market Access," Release No. 34-63241; File No. S7-03-10, Securities and Exchange Commission, November 2, 2010.

Rule.[82] Therefore, based on the SEC's own findings, compliance with the Market Access Rule would have prevented these two incidents, which both affected the equities market. The Proposal does not provide any examples for the fixed income market.

88. Furthermore, the Proposal does not adequately explain how dealer registration would address the operational risks of market participants who are not currently registered dealers. It simply claims that "PTFs and private funds also may not have the same obligations to implement operational risk controls."[83] [84] However, as explained above, these market participants who are not registered dealers trade through brokers who are subject to the Market Access Rule for any trades on exchanges or ATSs, for both equity and fixed income securities and private funds are subject to a comprehensive regulatory regime under the Investment Advisers Act of 1940.[85]

89. If the Commission is concerned about operational risks, it could consider addressing them within the existing framework of the Market Access Rule which already has effect over these market participants that trade through broker-dealers, rather than requiring them to register as dealers themselves. However, it fails to consider this direct regulatory approach among its "reasonable alternatives."[86]

C. Leverage

1. The Proposal Fails to Show That Excessive Leverage Imposes Negative Externalities on Other Market Participants.

90. While the Proposal describes how purported "liquidity providers" with excess leverage could in theory impose negative externalities on the market, it does not provide direct empirical support that demonstrates the existence of such externalities. Instead, it cites two research articles to support its claim: a Joint Staff Report of the Treasury market volatility in March 2020 and an academic publication about equities trading on NASDAQ in 2008 and 2009 (the

[82] Securities Exchange Act Release No. 70694; Securities Exchange Act Release No. 76029.
[83] Proposal, p. 117.
[84] The Proposal points to footnote 206 which reads "These regulatory requirements include, for example, pre-trade requirements such as exchange-trading rules relating to special order types, trading halts, odd-lot orders, and SEC rules under Regulation SHO and Regulation NMS, as well as post-trade obligations to monitor for manipulation and other illegal activity. Also, see supra note 78 on the Market Access Rule (15c3-5). See, e.g., 17 CFR § 240.15c3-5 (Exchange Act Rule 15c3-5)—Risk Management Controls for Brokers or Dealers with Market Access (the "Market Access Rule") promotes market integrity by reducing risks associated with market access by requiring financial and regulatory risk management controls reasonably designed to limit financial exposures and ensure compliance with applicable regulatory requirements."
[85] "Investment Advisers Act of 1940," Securities and Exchange Commission.
[86] Proposal, pp. 141–142.

NASDAQ Study).[87] However, neither of these articles demonstrates that excessive leverage by the liquidity providers identified in those markets imposed negative externalities on other market participants. At most, they document a well-understood characteristic in any market: liquidity providers tend to reduce their market-making activities in periods of high volatility because risk and inventory considerations make it more expensive to do so—a phenomenon that applies equally to banks and registered broker-dealers. The Proposal does not show how this phenomenon is related to excessive leverage.

91. According to the Proposal, when "liquidity providers" have excess leverage, they can impose negative externalities on other market participants in two ways:

> Instability in securities markets may appear when a failed liquidity provider exits the market or when a stressed liquidity provider temporarily reduces its activity, thereby reducing market liquidity for all traders until other liquidity providers can fill the gap.[88]
>
> Instability may also appear when a struggling market participant rapidly exits a large position in one or more securities, leading to volume and price spikes that can quickly push market prices away from fundamental values and can overwhelm exchanges and clearing houses.[89]

The Proposal's economic analysis does not demonstrate how frequently such events happen, which markets they occur in, and the costs they might impose on other market participants. Establishing a rigorous baseline is important to understanding whether there is a need for additional regulation.

92. As an initial matter, the Commission does not substantiate its claims that a "liquidity provider" withdrawing from the market or having to liquidate a position are examples of liquidity providers imposing negative externalities on other market participants. Changing liquidity provision in response to higher risk is a prudent risk management practice. The fact that other market participants temporarily have less liquidity available to them in the market may be an inconvenience to them, but this is not an example of a market failure.[90] Similarly, a fire

[87] Proposal, p. 118.
[88] Proposal, p. 118.
[89] Proposal, p. 118.
[90] In the textbook example of a negative externality, a widget factory polluting a river imposes negative externalities on unrelated third parties who use the river because the widget factory does not incorporate the effects of this pollution into its operating

sale primarily imposes costs on the party doing the fire sale and creates opportunities for other market participants but would not be considered a negative externality.

93. With regards to the purported problem of "liquidity providers" temporarily reducing their activity, the Proposal points to two specific examples of "market disruptions," without showing that either were due to excessive leverage on the part of those "liquidity providers." First, the Proposal cites to volatility in the Treasury market:

> During the U.S. Treasury market volatility in March 2020, PTFs [Principal Trading Firms] (most of whom are not registered as dealers) appeared to especially pull back from market-making activity, possibly because "their lower capitalization relative to dealers may [have left] them with less capacity to absorb adverse shocks.[91]

94. The Commission seems to overstate the findings of the IAWG Report when linking the reduced trading of PTFs to leverage. The IAWG Report documents that PTF volumes fell more than dealer volumes on the interdealer market during the 2020 period of volatility and merely speculates that their "lower capitalization relative to dealers may leave them with less capacity to absorb adverse shocks."[92] The IAWG Report does not analyze the capitalization of PTFs (or dealers), nor does it try to establish any causal link between PTF capitalization and their liquidity provision. Furthermore, leverage aside, rather than pointing to PTFs, other studies have linked the Treasury market disruption primarily to the activity of foreign central banks and registered mutual funds because these market participants had the largest contemporaneous portfolios of Treasury securities and were engaged in widespread selling.[93] Consistent with these studies, the IAWG Report also identifies heightened demand for liquidity as a contributing factor, and that this demand was primarily driven by "foreign officials and private investors."[94]

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decisions. However, a widget factory closing and depriving its customers of widgets is generally not considered a negative externality.

[91] Proposal, p. 118.

[92] "Recent Disruptions And Potential Reforms In The U.S. Treasury Market: A Staff Progress Report," U.S. Department of the Treasury, the Board of Governors of the Federal Reserve System, the Federal Reserve Bank of New York, the U.S. Securities and Exchange Commission, and the U.S. Commodity Futures Trading Commission, November 8, 2021 ("IAWG Report"), p. 13.

[93] "IOSCO Investment Funds Statistics Report," International Organization of Securities Commissions, January 2022 ("IOSCO Report"), p. 22; Barth, Daniel and R. Jay Kahn, "Hedge Funds and the Treasury Cash-Futures Disconnect," OFR Working Paper 21–01, April 1, 2021 ("Barth and Kahn (2021)"), p. 46 ("The illiquidity in Treasury markets seems to have been spurred by large sales from foreign and domestic real money investors, particularly foreign central banks and domestic mutual funds.").

[94] IAWG Report, p. 9 ("Foreign official and private investors. Foreign investors were significant net sellers of Treasury securities. More than half of the net sales were by foreign official institutions, such as central banks that sought to support local currencies.").

95. As a second example of "liquidity providers" temporarily reducing their activity, the Proposal states that:

> Other research also shows that, in equity markets, the presence of high-frequency traders can further reduce market liquidity during periods of extreme volatility (high frequency is one of the primary features of PTF activity, according to the 2015 Joint Staff Report).[95]

In addition to the NASDAQ study discussed above that documents the pullback of liquidity provision by high frequency trading ("HFT") firms during periods of high volatility, the Proposal cites additional academic articles,[96] none of which establish a link between excessive leverage and the reduction in liquidity during periods of high volatility. Moreover, in citing the NASDAQ study the Proposal seems to ignore that most of the largest HFT firms in equity markets are already registered as broker-dealers.[97] To the extent that the literature documents reductions in liquidity provision during periods of high volatility by HFT firms (registered as broker-dealers), this could be viewed as evidence that dealer registration does not solve the alleged problem.

96. Furthermore, reducing liquidity from the market during times of crisis is a natural response for any liquidity provider, including registered dealers. The tendency for registered broker-dealers to reduce their market making activity in periods of high volatility is well studied by the academic literature. Indeed, the IAWG 2021 Report on the March 2020 Treasury Market volatility notes that all market makers, both PTFs and dealers, reduced activity due to the changing risk environment.[98] From a theoretical perspective, market makers take on inventory risk whenever they provide liquidity because they bear the risk of adverse price movements while they wait to hedge an open position. During periods of high volatility, the cost of such adverse price movements increases, and it may become individually rational for the market maker to reduce trading. Indeed, individual risk management might dictate that the market

[95] Proposal, p. 118.
[96] See, e.g., Proposal footnotes 22, 216, and 242.
[97] See, e.g., "BrokerCheck Report Virtu Americas LLC," FINRA, available at https://files.brokercheck.finra.org/firm/firm_149823.pdf; "BrokerCheck Report Citadel Securities LLC," FINRA, available at https://files.brokercheck.finra.org/firm/firm_116797.pdf; "BrokerCheck Report Two Sigma Securities, LLC," FINRA, available at https://files.brokercheck.finra.org/firm/firm_148960.pdf; "BrokerCheck Report Latour Trading LLC," FINRA, available at https://files.brokercheck.finra.org/firm/firm_150887.pdf; "BrokerCheck Report Jump Execution, LLC," FINRA, available at https://files.brokercheck.finra.org/firm/firm_313060.pdf
[98] IAWG Report, pp. 13–14.

maker stop taking additional positions.[99] From a theoretical perspective, market makers face these considerations regardless of leverage, and regardless of whether they are registered as dealers. Thus, there appears to be no logical basis for citing these "market disruptions" as a justification for the Proposed Rules.

97. The Proposal does not provide any examples of the second way that it claims excessive leverage could cause negative externalities: "when a struggling market participant rapidly exits a large position in one or more securities, leading to volume and price spikes." This seems to be a general concern for any large market participant, rather than liquidity providers in particular. For example, in the recent Archegos case, the family office had built a substantial long position in a handful of stocks.[100] When Archegos collapsed, its prime brokers rushed to liquidate its positions to recover some capital, prompting a fire sale in those stocks.[101] However, Archegos does not appear to fall into the SEC's description of a "liquidity provider" or "*de facto* market maker."[102]

2. The Proposal Fails to Explain Why Purported Negative Externalities Due to Excessive Leverage are not Already Addressed by Existing Regulation.

98. There already exists a robust regulatory system to limit the potential negative externalities from excessive leverage for market participants who are not registered dealers, including the purported "liquidity providers" that the Commission is purportedly targeting. First, the leverage available to individual market participants who are not registered dealers is set by their brokers, who are limited by margin rules in the leverage they can offer. Second, if an individual market participant were to fail, to the extent their trades are cleared, their counterparties are protected by the clearing system, which isolates the rest of the market from the effects of individual failures. The Proposal does not explain why negative externalities due

[99] See, e.g., Ho, Thomas and Hans R. Stoll, "Optimal Dealer Pricing Under Transactions and Return Uncertainty," Journal of Financial Economics 9(1), 1980, pp. 47–73.

[100] Chung, Juliet and Maureen Farrell, "Ex-Tiger Asia Founder Triggers $20 Billion in Large Stocks Sales," The Wall Street Journal, March 28, 2021, available at https://www.wsj.com/articles/ex-tiger-asia-founder-triggers-30-billion-in-large-stocks-sales-11616973350.

[101] Chung, Juliet and Maureen Farrell, "Ex-Tiger Asia Founder Triggers $20 Billion in Large Stocks Sales," The Wall Street Journal, March 28, 2021, available at https://www.wsj.com/articles/ex-tiger-asia-founder-triggers-30-billion-in-large-stocks-sales-11616973350.

[102] See, "Complaint ECF Case Jury Trial Demanded," *Securities and Exchange Commission v. Sung Kook (Bill) Hwang, Patrick Halligan, William Tomita, Scott Becker, and Archegos Capital Management, LP*," United States District Court Southern District of New York, Case 1:22-cv-03402, April 27, 2022, p. 7 ("Generally, over time, Archegos pursued a long/short equity strategy, generally taking long exposures in single name issuers, and hedging those long exposures largely through short exposures to exchange-traded funds and custom baskets, with some limited short exposures to single name issuers, as well.")

excessive leverage is not already addressed by regulatory regime around margining that apply to these market participants.

99. As an initial matter, the Proposal's conclusion that "hedge funds are more leveraged than registered dealers" appears to be based on a crude comparison of aggregate liquid assets versus debt , which is not a legitimate "apples-to-apples" comparison.[103] Dealers and hedge funds are fundamentally different business models and use leverage differently: a dealer is primarily a market maker that typically maintains flat books, while a hedge fund has an investment thesis that typically uses leverage to enhance risk-adjusted returns and as part of its hedging and risk management strategies.

100. More importantly, the aggregate liquid assets to debt metric the Commission points to is not a meaningful measure of the amount of hedge fund risk. Nothing in the number implies that hedge fund leverage allows them to take excessive risks that are large enough to impose negative externalities on other market participants. To the contrary, academic research on hedge funds shows that hedge funds generally do not have high exposures to market risks.[104] In addition , funds with higher leverage tend to invest in lower-risk assets. As a result, hedge funds with higher leverage tend to have (if anything) lower, not higher risk.[105] Moreover, the qualitative prongs mean the Proposed Rules would apply specifically to hedge funds that are holding positions for less than a day or engaging in arbitrage or hedged strategies—these are not the kind of strategies associated with large exposures to market risks. Thus, even if some hedge funds operate with a relatively higher leverage ratio, this does not necessarily mean the risks they are taking on are large enough to impose negative externalities on the rest of the market.

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[103] See, Proposal pp. 116–117 ("[N]et capital requirements limit the leverage that dealers are allowed to take on, while PTFs and private funds have no regulatory leverage constraints. We estimate that qualifying hedge funds are more leveraged than registered dealers. As of the second quarter of 2021, registered investment advisers reported that qualifying hedge funds had $1.4 trillion in assets that could be liquidated within a day, $3.4 trillion in assets that could be liquidated within a year, and $3.6 trillion in secured debts, so that qualifying hedge funds' aggregate secured debt obligations appear much higher than their aggregate liquid assets. In contrast, the Net Capital Rule requires dealers to have highly liquid assets in excess of unsubordinated debt.").

[104] See e.g., Fung, William and David A. Hsieh, "A Primer on Hedge Funds," Journal of Empirical Finance 6(3), 1999, pp. 309–331 ("Table 3 provides the annualized returns and standard deviations of equally weighted portfolios of hedge funds and CTA funds. They have slightly lower returns than the S&P 500, but much lower volatility. In addition, they have low correlation with the S&P.").

[105] "[A]n emerging wave of theories of leverage constraints predict leverage and asset risk are negatively correlated, and therefore, leverage and portfolio risk may be unrelated or even negatively related. Consistent with theories of leverage constraints, we find that hedge fund leverage and portfolio risk are weakly negatively correlated." Barth, David, Laura Hammond, and Phillip Monin, "Leverage and Risk in Hedge Funds," OFR Working Paper 20-02, February 25, 2020.

101. While the Proposal claims that "private funds have no regulatory leverage constraints," it does not provide an analysis of the margining rules that already apply to the liquidity providers who are not registered dealers but have positions cleared at CCPs or are subject to bilateral requirements with dealer counterparties. Additionally, broker-dealers require their clients to post and maintain sufficient margin to be able to trade. Private funds obtain leverage from broker-dealers who face regulatory limits on the leverage that they can provide through margin accounts. The Commission has not shown why the leverage of market participants who are not registered dealers is not already addressed by margin regulation. Margin regulation encompasses an entire regime that governs how much leverage broker-dealers can provide their clients. As explained by FINRA: "The terms on which firms can extend credit for securities transactions are governed by federal regulation and by the rules of FINRA and the securities exchanges."[106]

102. In the Proposal, the Commission also describes how an insolvency could harm a failed market participant's creditors and "propagate through the financial system" to other market participants:

> A market participant who is unable to meet its obligations may harm its creditors, other financial institutions related to its creditors, its trading counterparties, and other participants in securities markets including investors. Although creditors can seek to estimate a borrower's probability of failure and price the credit extension accordingly, large losses can potentially propagate through the financial system—especially when indirect exposures are not well understood and financial firms misread their total exposure.[107]

However, the Proposal does not provide any examples, let alone an analysis of whether excess leverage is the source of the problem. In general, counterparty solvency is a greater concern for transactions where one side remains a long-term counterparty to the trade, such as in derivative securities. In this case, investors with long-term derivative positions would be exposed to the counterparty risk over the life of the contracts. The most obvious example is Lehman Brothers during the 2008 Financial Crisis. When Lehman Brothers failed, it was counterparty to many long-term derivatives contracts, both to end clients and other dealers. Counterparty exposures on those long-term contracts imposed costs on other market participants, in part, because Lehman

[106] "Margin Regulation," FINRA, available at https://www.finra.org/rules-guidance/key-topics/margin-accounts.
[107] Proposal, p. 117.

Brothers was a large dealer, but especially because its failure transmitted those losses to other dealers which impacted their ability to make markets.

103. However, the Proposal is not limited to traders of long-term derivatives contracts, but also would apply to spot trading in equities and Treasuries, which do not represent long-term counterparty risks. For these securities, counterparty risk is minimal because they are "cash" securities—equity trades clear on a two-day settlement cycle, and Treasury securities settle on a one-day cycle.[108]

104. The equity clearing system is designed to manage counterparty risk over this short settlement period. Parties who trade equities in the US, if they are not a registered broker-dealer themselves, do so through a registered broker who guarantees performance on the trade, and is already subject to the SEC's registration and net capital requirements.[109] Clearance and settlement is done through the DTCC, and its subsidiary the NSCC, which acts as a central counterparty clearinghouse for trades, further mitigating default risk.[110] While central clearing is less common for Treasuries, based on assumptions in the 2015 Joint Staff Report, about 23 percent of Inter-Dealer Broker (IDB) trades in 2017 were between two CCP members and were centrally cleared. The Proposal does not identify or analyze any failures in the clearing of equities or Treasuries. Indeed, the SEC is separately considering measures to expand the use of central clearing in the cash Treasury market and Treasury repo market.[111]

105. The equity clearing system has been effective in mitigating negative externalities by isolating the effects of individual defaults to prevent them from spilling over to other market participants. To my knowledge, there have been no CCP failures. If the SEC is concerned about this type of counterparty risk for Treasuries, a potential way to address it would be to expand the coverage of CCPs. The Proposal does not consider the merits of clearing versus dealer registration.

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[108] "SEC Adopts T+2 Settlement Cycle for Securities Transactions," U.S. Securities and Exchange Commission, March 22, 2017, available at https://www.sec.gov/news/press-release/2017-68-0.

[109] "Concept Release on Equity Market Structure," Release No. 34-61358; File No. S7-02-10, Securities and Exchange Commission, January 14, 2010, p. 28–31.

[110] "National Securities Clearing Corporation (NSCC)," DTCC, available at https://www.dtcc.com/about/businesses-and-subsidiaries/nscc.

[111] "SEC Proposes Rules to Improve Risk Management in Clearance and Settlement and to Facilitate Additional Central Clearing for the U.S. Treasury Market," U.S. Securities and Exchange Commission, September 14, 2022, available at https://www.sec.gov/news/press-release/2022-162,

3. The Proposal Does Not Show How Dealer Registration Would Reduce Leverage.

106. The Commission claims that dealer registration would impose greater leverage restrictions on market participants by imposing net capital requirements. However, the Proposal does not present an analysis of how applying net capital requirements on a fund already subject to margin requirements would affect its leverage. While Form PF data are not available to the public, the Commission has access to this regulatory data which could be the basis for this type of analysis. However, the Commission has not presented any such analysis in this Proposal.

107. The Commission does not show that net capital requirements would be more effective than existing margin regulation at managing excessive leverage. Existing margin regulation is already targeted to manage the leverage of investors in different markets. Margin rules attempt to account for different types of risks facing different types of investors. For example, margin rules account for different types of "concentration risk," the risk that a large proportion of a portfolio is exposed to a single risk factor, such as concentration in a particular stock, sector, asset class, geographical region, or even trading strategy. Furthermore, brokers generally apply stress test methodologies based on current market conditions on an individual asset basis to determine margin requirements for their clients. Thus, margin required for a given portfolio can change with market conditions. The Commission has not shown how static net capital requirements would be superior to the existing margin regulation at capturing these different risks.

108. If the Commission is concerned about excessive leverage, it should consider extending existing margin regulation for these investors, rather than requiring them to register as dealers. However, it fails to consider this direct regulatory approach as one of its "reasonable alternatives."[112]

D. The Proposal Has Not Considered Some Potential Unintended Consequences of Dealer Registration.

109. The Commission has not provided an analysis of potential unintended consequences of dealer registration. For example, it has not considered the impact of dealer registration on

[112] Proposal, pp. 141–142.

market liquidity, especially in the Treasuries market, the impact of losing access to IPOs, and the loss of customer protections. I discuss potential unintended consequences if the Proposal were adopted below.

1. Impact On Market Liquidity

110. If liquidity provision during high volatility periods is the Commission's primary concern, additional limits on leverage through net capital requirements might actually exacerbate the problem. From a theoretical perspective, tighter capital requirements could make it more difficult for liquidity providers to take positions during heightened volatility. As described above, liquidity providers bear inventory risks when they take positions, and those risks increase during periods of high volatility. If capital requirements limit the amount of risk that market makers can take during those periods, it could reduce their ability to provide liquidity. This issue is widely recognized by academics and policymakers. For example, in 2016, the European Systemic Risk Board conducted a survey of the largest market-makers in Europe and found that when asked about "the main determinants of market illiquidity" the most common answer was "capital and balance sheet constraints."[113] The Proposal does not appear to consider this countervailing impact of capital requirements on liquidity.

111. The Commission should also carefully consider the impact of regulation on market liquidity for the Treasuries market, in particular. As the Proposal itself acknowledges, "new market participants have established themselves as significant market intermediaries – and critical sources of liquidity – in the U.S. Treasury market."[114] Given the structural importance of these market participants, the Commission should analyze the potential for dealer regulation to reduce liquidity in this market.

112. In particular, the Commission has failed to analyze what would happen if market participants exited the Treasury market to avoid dealer registration. The Commission suggests that the impact could be small because "the increased regulatory burden would fall on relatively

[113] "Marketing Liquidity and Market-Making," European System Risk Board, October 2016, Chart 12, available at https://www.esrb.europa.eu/pub/pdf/reports/20161005_market_liquidity_market_making.en.pdf.

[114] Proposal, p. 7. The Proposal continues: "For example, by 2014, unregistered market participants trading U.S. Treasury securities, including PTFs, accounted for a majority of trading activity in the electronic interdealer market. The 2015 Joint Staff Report on the U.S. Treasury market found that more than 50 percent of trading volume in benchmark U.S. Treasury securities on the major trading platforms is attributable to PTFs. In 2020, staff at the Board of Governors of the Federal Reserve published a paper estimating that PTFs account for 61 percent of the trading activity on interdealer broker platforms."

few firms."[115] However, as shown above, their estimate that only 46 additional firms would face registration under the Proposal is unreliable and based on incomplete information. In fact, the Commission admits that there could be detrimental effects on liquidity and that the outcome is uncertain:

> [T]he Proposed Rules may cause some market participants to scale back or exit certain liquidity-providing strategies in order to avoid registration; or, even if they do not, compliance costs including net capital requirements might lead them to scale back some activities. If such reductions in liquidity provision occur, we cannot be certain that other market participants would arise to replace the lost liquidity. Even if other participants do eventually arise, lost liquidity can lead to mispricing in the short run.[116]

Indeed, the Federal Reserve's response to the reduction in Treasury market liquidity in March 2020 was to temporarily reduce capital requirements on banks to allow them to continue to intermediate.[117] Given the importance of the Treasury market and the wide-ranging impact of the Proposal, the Commission should address this uncertainty with economic analysis before imposing new rules.

113. Indeed, if the Commission is primarily concerned about the tendency for liquidity providers to reduce their market making activity in periods of high volatility, it could consider approaches that target that issue. Different markets have addressed this issue in different ways, for example, by providing liquidity providers with incentives to continue making markets even during periods when doing so might be particularly costly. The NYSE assigns specialists or designated market makers ("DMMs") which have an obligation to provide continuous quotes. As compensation, DMMs receive certain privileges. If the Commission is concerned about market makers scaling back activity in highly volatile periods in the Treasury market, they should at least consider alternative approaches that have been tried in other markets.

[115] Proposal, p. 140.
[116] Proposal, pp. 140–141.
[117] IAWG Report, p. 17.

2. Access to IPOs

114. The Commission fails to recognize that dealer registration would bar affected hedge funds from accessing IPOs.[118] I understand that this would not only apply to the fund entity that is covered by dealer registration but also extend to certain of its limited partners who would become "restricted persons" under FINRA rules. This could affect the willingness of investors to become limited partners in funds covered by dealer registration. Access to IPOs does not appear to be aligned with the economic problems that the Commission is purportedly targeting (financial risks, operational risks, and transparency), and they have not considered barriers to access as a potential unintended consequence of the proposed regulation.

3. Loss of Customer Protections

115. The Commission has also not considered that requiring hedge funds to register as dealers would cause them to lose the benefit of various customer protection regulations that govern their relations with their broker-dealers. I understand that registered dealers do not count as "customers" when interacting with broker-dealers. Thus, if compelled to register as dealers, hedge funds would lose various customer protections including, for example, restrictions on markups and obligations to provide fair prices (FINRA Rule 2121), best execution requirements (FINRA Rule 5310), and prohibitions on trading ahead of customer orders (FINRA Rule 5320). Removing customer protections does not appear to be aligned with the economic problems that the Commission is purportedly targeting (financial risks, operational risks, and transparency). This is another potential unintended consequence of the proposed regulation.

[118] "5310. Best Execution and Interposition," FINRA, available at https://www.finra.org/rules-guidance/rulebooks/finra-rules/5310.