

## SECURITIES AND EXCHANGE COMMISSION

### 17 CFR Part 240

[Release No. 34–94524; File No. S7–12–22]

RIN 3235–AN10

### Further Definition of “As a Part of a Regular Business” in the Definition of Dealer and Government Securities Dealer

**AGENCY:** Securities and Exchange Commission.

**ACTION:** Proposed rule.

**SUMMARY:** The Securities and Exchange Commission (“Commission”) is proposing new rules to further define the phrase “as a part of a regular business” as used in the statutory definitions of “dealer” and “government securities dealer” under Sections 3(a)(5) and 3(a)(44), respectively, of the Securities Exchange Act of 1934 (“Exchange Act”).

**DATES:** Comments should be received on or before May 27, 2022.

**ADDRESSES:** Comments may be submitted by any of the following methods:

#### *Electronic Comments*

- Use the Commission’s internet comment form (<https://www.sec.gov/rules/submitcomments.htm>); or
- Send an email to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number S7–12–22 on the subject line.

#### *Paper Comments*

- Send paper comments to Vanessa A. Countryman, Secretary, Securities and Exchange Commission, 100 F Street NE, Washington, DC 20549–1090.

All submissions should refer to File Number S7–12–22. This file number should be included on the subject line if email is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission’s internet website (<https://www.sec.gov/rules/proposed.shtml>). Comments also are available for website viewing and printing in the Commission’s Public Reference Room, 100 F Street NE, Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. Operating conditions may limit access to the Commission’s public reference room. Persons submitting comments are cautioned that we do not redact or edit personal identifying information from comment submissions. You should

submit only information that you wish to make available publicly.

Studies, memoranda, or other substantive items may be added by the Commission or staff to the comment file during this rulemaking. A notification of the inclusion in the comment file of any such materials will be made available on the Commission’s website. To ensure direct electronic receipt of such notifications, sign up through the “Stay Connected” option at [www.sec.gov](http://www.sec.gov) to receive notifications by email.

#### **FOR FURTHER INFORMATION CONTACT:**

Emily Westerberg Russell, Chief Counsel; John Fahey, Deputy Chief Counsel; Joanne Rutkowski, Assistant Chief Counsel; Shauna Sappington Vlosich, Senior Special Counsel; James Blakemore, Special Counsel; or Katherine Lesker, Special Counsel at 202–551–5550 in the Office of Chief Counsel, Division of Trading and Markets, Securities and Exchange Commission, 100 F Street NE, Washington, DC 20549–7010.

**SUPPLEMENTARY INFORMATION:** The Commission is proposing the following new rules under the Exchange Act: (1) 17 CFR 3a5–4 (Rule 3a5–4) and (2) 17 CFR 3a44–2 (Rule 3a44–2) (collectively, the “Proposed Rules”).

#### **I. Introduction**

Advancements in electronic trading across securities markets have led to the emergence of certain market participants that play an increasingly significant liquidity providing role in overall trading and market activity—a role that has traditionally been performed by entities regulated as dealers.<sup>1</sup> However, these market

<sup>1</sup> See Department of the Treasury, Notice Seeking Comment on the Evolution of the U.S. Treasury Market Structure, 81 FR 3928 (Jan. 22, 2016) (“Treasury Request for Comment”). See also Joint Staff Report: The U.S. Treasury Market on October 15, 2014 (July 13, 2015) (“2015 Joint Staff Report”), prepared by staff of the U.S. Department of the Treasury, Board of Governors of the Federal Reserve System, Federal Reserve Bank of New York, U.S. Securities and Exchange Commission, and U.S. Commodity Futures Trading Commission, available at <https://www.sec.gov/reportspubs/special-studies/treasury-market-volatility-10-14-2014-joint-report.pdf>. The 2015 Joint Staff Report is a report of the Inter-Agency Working Group for Treasury Market Surveillance (“IAWG”). Staff reports, Investor Bulletins, and other staff documents (including those cited herein) represent the views of Commission staff and are not a rule, regulation, or statement of the Commission. The Commission has neither approved nor disapproved the content of these staff documents and, like all staff statements, they have no legal force or effect, do not alter or amend applicable law, and create no new or additional obligations for any person. See also Concept Release Concerning Equity Market Structure, Exchange Act Release No. 61358 (Jan. 14, 2010), 75 FR 3594 (Jan. 21, 2010) (“2010 Equity Market Structure Concept Release”) at 3594–96 (discussing the evolution from “a market structure

participants—despite engaging in liquidity providing activities similar to those traditionally performed by either “dealers” or “government securities dealers” as defined under Sections 3(a)(5) and 3(a)(44) of the Exchange Act, respectively, and despite their significant share of market volume<sup>2</sup>—may not be registered with the Commission as either dealers or government securities dealers under Sections 15 and 15C of the Exchange Act, respectively.<sup>3</sup> Because of this, investors and the markets lack the important protections that result from an entity’s registration and regulation under the Exchange Act. In addition, obligations and regulatory oversight that promote market stability and investor protection are not being consistently applied to entities engaged in similar activities.

The Commission believes that the identification and registration of these market participants as dealers, including those that are not currently regulated as dealers, would provide regulators with a more comprehensive view of the markets through regulatory oversight and would enhance market stability and investor protection.<sup>4</sup> Accordingly, the Commission is proposing to further define what it means to be buying and selling securities “as a part of a regular business” within the definitions of “dealer” and “government securities dealer” under Sections 3(a)(5) and 3(a)(44), respectively.

#### *Evolution of the Market*

Advancements in technology have affected securities trading across markets and asset classes; however, regulation has not always kept pace. This is especially true in the U.S. Treasury market in view of the increasingly significant role played by market intermediaries that are not registered as dealers. The U.S. Treasury market has evolved significantly over

with primarily manual trading to a market structure with primarily automated trading.”)

<sup>2</sup> FEDS Notes, “Principal Trading Firm Activity in Treasury Cash Markets,” James Collin Harkrader and Michael Puglia (Aug. 4, 2020) (“[Principal trading firms] dominate activity on the electronic [interdealer broker] platforms (61 [percent].”). For purposes of this release, the terms “principal trading firms” and “proprietary trading firms” (collectively, “PTFs”) will be used interchangeably.

<sup>3</sup> As used in this release, the term “dealer” refers to both dealers and government securities dealers unless explicitly noted or the context indicates otherwise.

<sup>4</sup> As discussed in Section V below, the Commission believes that the Proposed Rules would support orderly markets and protect investors by addressing negative externalities that may arise in relation to market participants’ financial and operational risks.

recent decades in at least two important ways. First, the amount of U.S. Treasury securities outstanding has increased substantially.<sup>5</sup> At the end of 2007, Treasury debt held by the public totaled \$5.1 trillion, or 35 percent of that year's gross domestic product ("GDP").<sup>6</sup> That number rose to \$23.1 trillion, or 96.5 percent of GDP, by the end of 2021.<sup>7</sup>

Second, a significant rise in electronic trading in the interdealer market<sup>8</sup> for U.S. Treasury securities has contributed to a dramatic change in the overall structure of the market. In particular, technological advances have increasingly enabled certain market participants that are not registered as dealers to perform critical market functions, including liquidity provision, that once were primarily performed by regulated dealers.<sup>9</sup> Since the mid-2000s, electronic trading has come to dominate the interdealer market for U.S. Treasury securities, gradually supplanting manual transactions made via the

<sup>5</sup> See IAWG Joint Staff Report, Recent Disruptions and Potential Reforms in the U.S. Treasury Market: A Staff Progress Report prepared by U.S. Department of the Treasury, Board of Governors of the Federal Reserve System, Federal Reserve Bank of New York, U.S. Securities and Exchange Commission, U.S. Commodity Futures Trading Commission (Nov. 8, 2021) ("2021 IAWG Joint Staff Report").

<sup>6</sup> See *id.*

<sup>7</sup> See Monthly Statement of the Public Debt of the United States (Dec. 31, 2021), available at <https://www.treasurydirect.gov/govt/reports/pd/mspd/2021/opds122021.pdf>; see also U.S. Bureau of Economic Analysis, Gross Domestic Product (GDP), FRED, Fed. Res. Bank of St. Louis, available at <https://fred.stlouisfed.org/series/GDP>.

<sup>8</sup> The U.S. Treasury market is comprised of the cash market (purchases and sales of securities), the repo market, and the futures market. The U.S. Treasury cash market has been traditionally bifurcated between the interdealer market (whereby dealers trade with other dealers or with proprietary trading firms) and the dealer-to-customer market (whereby dealers trade with clients). Trading in electronic interdealer markets occurs anonymously on electronic trading platforms known as interdealer broker platforms ("IDBs"). Trading on the IDB platforms is similar to trading on other highly liquid markets and where certain market participants account for a significant trading volume. See Treasury Request for Comment at 3928. For purposes of this release, when discussing the U.S. Treasury market, we will be primarily focused on trading activities occurring in the interdealer market.

<sup>9</sup> 2021 IAWG Joint Staff Report at 5. A bank engaged in these activities would not register with the Commission as a dealer. See Exchange Act Section 3(a)(5)(C)(i)(II) (providing an exception from dealer status when a bank buys or sells exempted securities, which are defined in Exchange Act Section 3(a)(12)(A) to include government securities); see also Exchange Act Section 3(a)(6) (definition of "bank"). As discussed *infra* note 41, a bank may nonetheless be a government securities dealer required to register under Section 15C. As such, it would not register with the Commission but instead would provide written notice of its government securities dealer status with the appropriate Federal banking regulator, and comply with rules adopted by the Treasury and the applicable Federal banking regulator.

telephone.<sup>10</sup> The proliferation of fully electronic trading venues has been accompanied by the rise of certain market participants who are not registered as dealers and who today account for a majority of trading in the Treasury interdealer market.<sup>11</sup> In particular, PTFs—businesses that often employ automated, algorithmic trading strategies (including passive market making, arbitrage, and structural and directional trading)<sup>12</sup> that rely on speed, which allows them to quickly execute trades, or cancel or modify quotes in response to perceived market events<sup>13</sup>—account for about half of the daily volume in the interdealer market.<sup>14</sup>

These new market participants have established themselves as significant

<sup>10</sup> See Treasury Request for Comment. See also Group of Thirty Working Group on Treasury Market Liquidity, U.S. Treasury Markets: Steps toward Increased Resilience, Group of Thirty (2021) ("G30 Report") at <https://group30.org/publications/detail/4950>; 2021 IAWG Joint Staff Report at 5.

<sup>11</sup> See Michael J. Fleming, Bruce Mizrach, and Giang Nguyen, Federal Reserve Bank of New York Staff Reports, The Microstructure of a U.S. Treasury ECN: The BrokerTec Platform, Staff Report No. 381 (July 2009, rev. May 2014); see also Treasury Request for Comment ("Trading on these platforms [in the Treasury cash market] has become increasingly automated, with transactions conducted using algorithmic and other trading strategies involving little or no human intervention . . . bear[ing] some resemblance to other highly liquid markets, including equities and foreign exchange markets, where PTFs and dealers transact in automated fashion, sometimes in large volumes and at high speed."); FEDS Notes, "Principal Trading Firm Activity in Treasury Cash Markets," James Collin Harkrader and Michael Puglia (Aug. 4, 2020); G30 Report at 1. The Commission separately has proposed, among other things, amendments to Exchange Act Rule 3b-16 to include within the definition of "exchange" systems that offer the use of non-firm trading interest and communication protocols to bring together buyers and sellers of securities. See 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, Securities Exchange Act Release No. 94062 (Jan. 26, 2022), 87 FR 15496 (Mar. 18, 2022) ("2022 ATS Proposing Release").

<sup>12</sup> See Staff Report on Algorithmic Trading in U.S. Capital Markets As Required by Section 502 of the Economic Growth, Regulatory Relief, and Consumer Protection Act of 2018 (Aug. 5, 2020) ("Algorithmic Trading Staff Report"), at pp. 39–41 ("Passive market-making involves submitting non-marketable orders on both sides (buy or 'bid,' and sell or 'offer') of the marketplace"; "structural strategies attempt to exploit structural vulnerabilities in the market or in certain market participants"; and "directional strategies generally involve establishing a short-term long or short position in anticipation of a price move up or down"); see also 2010 Equity Market Structure Concept Release.

<sup>13</sup> See 2022 ATS Proposing Release at 15597. See also 2015 Joint Staff Report at 39; 2021 IAWG Joint Staff Report at 5 ("PTFs tend to make trading decisions primarily based on immediate profitability and the level of market risk").

<sup>14</sup> Nellie Liang and Pat Parkinson, Hutchins Center Working Paper #72, Enhancing Liquidity of the U.S. Treasury Market Under Stress (Dec. 16, 2020) ("Enhancing Liquidity"), at 6.

market intermediaries—and critical sources of liquidity—in the U.S. Treasury market. 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.<sup>15</sup> 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.<sup>16</sup> 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.<sup>17</sup> The significant presence of market participants that are not registered as dealers or government securities dealers in the U.S. Treasury market, the volume of their trading, the magnitude of their impact on the market, the regularity of their participation, and in many cases the nature of their electronic trading strategies have all contributed to the increasingly central role of these market participants as liquidity providers.<sup>18</sup>

The rise of electronic trading has similarly impacted the market structure of the securities markets generally. In the equity markets, for example, trading in exchange-listed equities, once concentrated on exchange floors, now largely occurs in an electronic, highly decentralized but interconnected market that is accessed by brokers, dealers, and other market participants using a large number and great variety of trading venues.<sup>19</sup> In the equity markets, too, technological advances have enabled significant market participants to take on an increasingly central role as liquidity providers, largely replacing more traditional types of traditional liquidity providers, such as exchange specialists on manual trading floors and over-the-counter ("OTC") market makers.<sup>20</sup> Technological advancements

<sup>15</sup> See 2021 IAWG Joint Staff Report at 5.

<sup>16</sup> See 2015 Joint Staff Report at 21.

<sup>17</sup> FEDS Notes, "Principal Trading Firm Activity in Treasury Cash Markets," James Collin Harkrader and Michael Puglia (Aug. 4, 2020) (citing data presented at the 2019 U.S. Treasury Market Conference showing that PTFs averaged approximately 61 percent of total trading volume on electronic interdealer broker platforms).

<sup>18</sup> 2015 Joint Staff Report; Enhancing Liquidity at 6.

<sup>19</sup> See 2010 Equity Market Structure Concept Release at 3594.

<sup>20</sup> See 2010 Equity Market Structure Concept Release at 3607 (stating that liquidity providers historically have been viewed as dealers, and that "[a]lthough [PTFs] that employ passive market making strategies are a new type of market participant, the liquidity providing function they perform is not new.").

have prompted changes to trading practices, particularly with regard to the way in which orders are generated, routed, and executed. Developments in securities regulation also have contributed to the evolution of market structure and the rise of electronic trading.<sup>21</sup> These technological and regulatory changes have resulted in the development of highly automated exchange systems and trading tools that have facilitated a business model for certain market participants, including PTFs, that perform functions similar to registered dealers.<sup>22</sup>

As discussed below, the Commission has long identified liquidity provision, including acting as a “market maker” or “a *de facto* market maker whereby market professionals or the public look to the firm for liquidity,” as a factor that indicates “dealer” status.<sup>23</sup> Analysis indicates a number of market participants that, despite their significant share of market volume and their central role as liquidity providing intermediaries in the U.S. Treasury market, are not registered with the

<sup>21</sup> In 2005, the Commission adopted 17 CFR 242.600 through 242.614 (Regulation NMS), a series of initiatives designed to modernize and strengthen the national market system for equity securities through improved fairness in price execution, displaying of quotes, and access to market data. Exchange Act Release No. 51808 (June 9, 2005), 70 FR 37495 (“Regulation NMS Release”). As these initiatives were implemented, regulations that had protected the manual quotes of floor exchanges from trade-throughs were rescinded. *Id.* In 2006, after decades of trading predominantly on the exchange floor, the New York Stock Exchange (“NYSE”) introduced a hybrid market structure that incorporated an ability to transact electronically. See 2010 Equity Market Structure Concept Release. Today, electronic trading dominates transactions in equity securities.

<sup>22</sup> A significant portion of trading activity in the equity markets—once estimated at 40–50 percent of the daily trading volume in exchange-listed equities—is conducted by PTFs. See High Frequency Trading and Networked Markets, Federico Musciotto, Jyrki Piilo, Rosario N. Mantegna (Mar. 5, 2021); SEC Staff of the Division of Trading and Markets, Equities Market Structure Literature Review Part II: High Frequency Trading (Mar. 18, 2014); Do High-Frequency Traders Anticipate Buying and Selling Pressure?, Nicholas H. Hirschey (Nov. 2013); High-Frequency Trading and Price Discovery, Jonathan Brogaard, Terrance Hendershott, Ryan Riordan (May 14, 2014); High Frequency Trading: An Important Conversation, available at <https://tabforum.com/opinions/high-frequency-trading-an-important-conversation> (Mar. 24, 2014) (illustrating the percentage of high frequency trading of U.S. equity shares traded from 2006 to 2014 in Exhibit 1). See also Section V.B.2.

<sup>23</sup> Definition of Terms in and Specific Exemption for Banks, Savings Associations, and Savings Banks Under Sections 3(a)(4) and 3(a)(5) of the Securities Exchange Act of 1934, Exchange Act Release No. 46745 (Oct. 30, 2002), 67 FR 67496, 67498–67500 (Nov. 5, 2002) (“2002 Release”) (stating that a person generally may satisfy the definition, and therefore, be acting as a dealer in the securities markets by conducting various activities, including “acting as a market maker or specialist on an organized exchange or trading system”).

Commission either as “government securities dealers” under Section 15C of the Exchange Act or “dealers” under Section 15 of the Exchange Act.<sup>24</sup> This has resulted in an uneven playing field in which some participants are subject to regulation (and its attendant costs and benefits), and some are not. This uneven application of regulatory oversight of significant liquidity providers makes it difficult for regulators and market observers to detect, investigate, understand, or address market events, such as the “flash rally” in October 2014.

As discussed below, the regulatory regime applicable to dealers is a cornerstone of the U.S. Federal securities laws, and helps to promote the Commission’s long-standing mission to protect investors, maintain fair, orderly, and efficient markets, and promote capital formation. As discussed in Sections II.D, and V.C, the registration of market participants who engage in significant dealer-like activities—but who are not currently registered as dealers—would provide regulators with a more comprehensive view of the markets through regulatory oversight, as well as enhance market stability through compliance with dealer regulations that are designed to support orderly markets, and protect investors by minimizing the impact of market participants’ potential financial and operational risks.<sup>25</sup> Accordingly, the Commission is taking steps to ensure that these market participants are registered and regulated,<sup>26</sup> and is

<sup>24</sup> See Section V.B.2.a, Table 1. 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.” Similarly, Section 3(a)(44) of the Exchange Act, provides, in relevant part, that the term “government securities dealer” means “any person engaged in the business of buying and selling government securities for his own account, through a broker or otherwise,” but “does not include any person insofar as he buys or sells such securities for his own account, either individually or in some fiduciary capacity, but not as part of a regular business.” See Section II.A.

<sup>25</sup> Section V.C.2 describes the estimated costs associated with registering as a dealer or government securities dealer for those persons who meet the proposed standards.

<sup>26</sup> In addition, earlier this year, the Commission proposed to amend 17 CFR 242.300 through 242.304 (Regulation ATS) for alternative trading systems (“ATSs”) that trade government securities (as defined under Section 3(a)(42) of the Exchange Act) or repurchase and reverse repurchase agreements on government securities (“repos”) (such ATSs, together, “Government Securities ATSs”) to: (1) Eliminate the current exemption from compliance with Regulation ATS for an ATS that limits its securities activities to government securities or repos, and registers as a broker-dealer

proposing for comment rules to further define the regulatory status of certain participants as “dealers” and “government securities dealers,” within the meaning of Sections 3(a)(5) and 3(a)(44) of the Exchange Act, respectively.<sup>27</sup>

Specifically, the Commission is proposing standards to identify those market participants that are providing an important liquidity provision function in today’s securities markets. Any person<sup>28</sup> that meets the activity-based standards identified in the Proposed Rules would be a dealer or government securities dealer required to register, absent an otherwise available and applicable statutory or regulatory exemption or exception (e.g., foreign broker-dealers exempted pursuant to 17 CFR 240.15a–6 (Exchange Act Rule 15a–6)).<sup>29</sup>

or is a bank; (2) require the filing of public Form ATS–N for Government Securities ATSs, which would be subject to Commission review and ineffectiveness procedures, and would require a Government Securities ATS to disclose information about its manner of operations and the ATS-related activities of the registered broker-dealer or government securities broker or government securities dealer that operates the ATS and its affiliates; and (3) apply the fair access rule under 17 CFR 242.301(b)(5) (Rule 301(b)(5) of Regulation ATS) to Government Securities ATSs that meet certain volume thresholds in U.S. Treasury Securities or in a debt security issued or guaranteed by a U.S. executive agency, or government-sponsored enterprise (“Agency Securities”). See 2022 ATS Proposing Release. The 2022 ATS Proposing Release is also re-proposing amendments to 12 CFR 242.1000 through 242.1007 (Regulation Systems Compliance and Integrity (“Regulation SCI”)) to apply it to Government Securities ATSs that meet certain volume thresholds in U.S. Treasury Securities or Agency Securities.

<sup>27</sup> We have consulted with the staff of the U.S. Department of the Treasury on this proposal.

<sup>28</sup> As discussed more fully below, the standards in the Proposed Rules do not apply to a person that has or controls total assets of less than \$50 million, or an investment company registered under the Investment Company Act of 1940 (“Investment Company Act”) (such company a “registered investment company”). See proposed Rule 3a5–4(a)(2) and proposed Rule 3a44–2(a)(3). Investment advisers are not required to aggregate accounts held in the name of clients of the adviser under certain circumstances as described in proposed Rule 3a5–4(b)(2)(ii) and proposed Rule 3a44–2(b)(2)(ii). See Section III.D.

<sup>29</sup> There is an analogous exemption under the Treasury rules for certain foreign government securities dealers. See 17 CFR 401.7 (Treas. Reg. § 401.7) (1987) (“Exemption for certain foreign government securities brokers or dealers.”). The Commission is not expressing any views concerning multilateral development banks, like the International Bank for Reconstruction and Development (or the World Bank) and the International Finance Corporation, or foreign sovereigns or foreign central banks, or any other sovereign or international bodies as to the immunities such entities may possess under U.S. or international law. See, e.g., Security-Based Swap Transactions Connected With a Non-U.S. Person’s Dealing Activity That Are Arranged, Negotiated, or Executed by Personnel Located in a U.S. Branch or Office or in a U.S. Branch or Office of an Agent;

As the Proposed Rules focus on activity rather than label or status, they would potentially scope in other market participants as discussed below in Section V, thereby triggering a registration requirement and subjecting those entities to dealer regulation and oversight. As discussed further in Section V.B.2, the Commission's analysis indicates that the Proposed Rules would primarily require registration by PTFs, and potentially some private funds.<sup>30</sup> In addition, it is possible that the activities of some investment advisers<sup>31</sup> could meet the Proposed Rules<sup>32</sup> and trigger a dealer registration requirement. The Commission believes the scope of the Proposed Rules is appropriate in light of the important liquidity that these participants provide to the securities markets, which is similar to that historically provided by regulated dealers.

The Commission is proposing to exclude certain smaller participants, as well as registered investment companies, from the ambit of the Proposed Rules. As discussed in Section III.A and V.B, these smaller participants—persons that have or control less than \$50 million in total assets—are unlikely to be able to engage in the significant liquidity provision that is the focus of the Proposed Rules. As discussed below in Section III.A, in light of the regulatory structure that governs registered investment companies, which addresses, among other things, the types of concerns that we seek to address in the Proposed Rules, the Commission is proposing to exclude registered investment companies from the Proposed Rules.<sup>33</sup>

Conversely, the Proposed Rules would not exclude private funds

because we are proposing to take a similar approach to regulating dealer activity across market participants and, unlike registered investment companies, private funds are not subject to the regulatory framework of the Investment Company Act. The Commission currently receives information about the operations, exposures, liabilities, liquidity, and strategies of private funds through filings of Form PF by registered private fund advisers and has recently proposed amendments to Form PF to enhance the reporting about private funds.<sup>34</sup> If excluded from the Proposed Rules, however, private funds engaged in dealer activity would not be subject to the dealer regulatory regime, which includes not only registration obligations, but also comprehensive regulatory requirements and oversight that broadly focus on market functionality—that is, the impact of dealing activity on the market as a whole.

The Proposed Rules also would not exclude investment advisers registered under the Advisers Act (“registered investment advisers”). A registered investment adviser trading for its own proprietary account, for example, could trigger the dealer registration requirements under the Proposed Rules. And, under certain circumstances, a registered investment adviser could trigger application of the Proposed Rules because of aggregating trading in its own account with client accounts it controls. However, as described below in Section III.D, in determining whether its activity would be captured by the Proposed Rules, a registered investment adviser would not be required to aggregate its own trading activities with the trading activities of its clients’ solely based on an adviser-client discretionary investment management relationship.<sup>35</sup> This exclusion is designed to attribute the dealer activity to the appropriate market actor.

## II. Background

The Federal securities laws provide a comprehensive system of regulation of

securities activities, and the definition of dealer is one of the Exchange Act’s most important definitions. As discussed below, the statutory definition of “dealer” in Section 3(a)(4) and the accompanying registration requirements of the Exchange Act were drawn broadly by Congress in 1934 to encompass a wide range of activities involving the securities markets and their participants.<sup>36</sup> Registered dealers and government securities dealers are subject to a panoply of regulatory obligations and supervisory oversight intended to protect investors and the securities markets. Therefore, it is important that market participants whose securities activities fall within the broad definitions of “dealer” and “government securities dealer” are registered and regulated under the Exchange Act.

### A. Definitions of “Dealer” and “Government Securities Dealer”

Section 3(a)(5) of the Exchange Act defines the term “dealer” to mean “any person<sup>37</sup> 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.”<sup>38</sup> This statutory exclusion from the definition of “dealer” is often referred to as the “trader” exception.<sup>39</sup>

<sup>36</sup> Proposed Rule 3a5–4 would apply to securities as defined by Section 3(a)(10) of the Exchange Act, and proposed Rule 3a44–2 would apply to government securities as defined by Section 3(a)(42) of the Exchange Act, including any digital asset that is a security or a government security within the meaning of the Exchange Act.

<sup>37</sup> Paragraph (b)(1) of the Proposed Rules provides that the term “person” has the same meaning as prescribed in Section 3(a)(9) of the Exchange Act. Section 3(a)(9) of the Exchange Act defines a “person” as “a natural person, company, government, or political subdivision, agency, or instrumentality of a government.” See 15 U.S.C. 78c(a)(9).

<sup>38</sup> See Sections 3(a)(5)(A) and (B) of the Exchange Act, 15 U.S.C. 78c(a)(5)(A) and (B). The definition of “dealer” in the Exchange Act is largely unchanged from its enactment in 1934. Until the Gramm-Leach-Bliley Act (“GLBA”) was enacted in 1999, banks were excluded from the definition of “dealer.” The GLBA added Section 3(a)(5)(C) of the Exchange Act to create a series of functional exemptions from the statutory definition of dealer. The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“Dodd-Frank Act”) further amended Section 3(a)(5)(A) of the Exchange Act to exclude from the dealer definition persons engaged in the business of buying and selling security-based swaps, other than security-based swaps with or for persons that are not eligible contract participants.

<sup>39</sup> See, e.g., 2002 Release (explaining that “a person that is buying securities for its own account may still not be a ‘dealer’ because it is not ‘engaged in the business’ of buying and selling securities for its own account as part of a regular business.” and

Security-Based Swap Dealer De Minimis Exception, Exchange Act Release No. 77104 (Feb. 10, 2016), 81 FR 8598, available at <https://www.govinfo.gov/content/pkg/FR-2016-02-19/pdf/2016-03178.pdf>.

<sup>30</sup> A private fund, including a hedge fund, is an issuer that would be an investment company as defined in Section 3 of the Investment Company Act if not for Section 3(c)(1) or 3(c)(7) of the Investment Company Act. See 15 U.S.C. 80a–3.

<sup>31</sup> “Investment adviser” is defined under the Investment Advisers Act of 1940 (“Advisers Act”) as “any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities.” See 15 U.S.C. 80b–2(a)(11).

<sup>32</sup> See Section III.D.

<sup>33</sup> As discussed in Section III.D, for purposes of the definition of “own account,” an account held in the name of a person that is a registered investment company would not be attributed to a controlling person or another person under common control.

<sup>34</sup> See Amendments to Form PF to Require Current Reporting and Amend Reporting Requirements for Large Private Equity Advisers and Large Liquidity Fund Advisers, Investment Advisers Act Release No. 5950 (Jan. 26, 2022), 87 FR 9106 (Feb. 17, 2022) (“Form PF Proposing Release”).

<sup>35</sup> Paragraph (b)(2)(ii)(B) of the Proposed Rules would not attribute to a registered investment adviser an account held in the name of a client of the registered investment adviser, unless the adviser controls the client as a result of the adviser’s right to vote or direct the vote of voting securities of the client, the adviser’s right to sell or direct the sale of voting securities of the client, or the adviser’s capital contributions to or rights to amounts upon dissolution of the client.

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.”<sup>40</sup> Read together, these provisions identify as a “dealer” a person engaged in the business of buying and selling securities for its own account as part of a regular business. Absent an exception or an exemption, Section 15(a)(1) of the Exchange Act makes it unlawful for a “dealer” to effect any transactions in, or to induce or attempt to induce the purchase or sale of, any security unless registered with the Commission in accordance with Section 15(b) of the Exchange Act.

Similarly, Section 3(a)(44) of the Exchange Act provides, in relevant part, that the term “government securities dealer” means “any person engaged in the business of buying and selling government securities for his own account, through a broker or otherwise,” but “does not include any person insofar as he buys or sells such securities for his own account, either individually or in some fiduciary capacity, but not as part of a regular business.”<sup>41</sup> Read together, these

that “[t]his exclusion is often referred to as the dealer/trader distinction”).

<sup>40</sup> See Loss, *Securities Regulation* 722 (1st ed. 1951) (“One aspect of the ‘business’ concept is the matter of drawing the line between a ‘dealer’ and a trader—an ordinary investor who buys and sells for his own account with some frequency.”), cited in Further Definition of “Swap Dealer,” “Security-Based Swap Dealer,” “Major Swap Participant,” “Major Security-Based Swap Participant” and “Eligible Contract Participant,” Exchange Act Release No. 66868 (Apr. 27, 2012), 77 FR 30596 n.250 (May 23, 2012) (“Entities Adopting Release”).

<sup>41</sup> 15 U.S.C. 78c(a)(44). Congress added the definition of “government securities dealer” to the Exchange Act in the Government Securities Act of 1986. Public Law 99-571, 100 Stat. 3208 (Oct. 28, 1986). To the extent a financial institution is a government securities dealer required to register under Section 15C, it would not register with the Commission but instead would provide written notice of its government securities dealer status with the appropriate Federal banking regulator, and comply with rules adopted by the Treasury and the applicable Federal banking regulator. See Regulations under Section 15C of the Securities Exchange Act of 1934, 17 CFR 400.1(b), available at CFR-2018-title17-vol4-chapIV.pdf (treasurydirect.gov) (the “Treasury Rules”). The Treasury Rules address financial responsibility, protecting customer securities and funds, recordkeeping, large position reporting, and financial reporting and audits. Also included are rules concerning custodial holdings of government securities by depository institutions. The Commission retains broad antifraud authority over banks that are government securities dealers. Soon after enactment of the Government Securities Act of 1986, the staff issued a series of no-action letters to persons seeking assurances that the staff would not recommend enforcement action if they did not register as government securities dealers. See, e.g., *Bankers Guarantee Title & Trust Co.*, SEC No-Action Letter (Jan. 22, 1991); *Bank of America*,

provisions identify as a “government securities dealer” a person engaged in the business of buying and selling government securities for its own account as part of a regular business.<sup>42</sup> Section 15C of the Exchange Act makes it unlawful for a “government securities dealer” (other than a registered broker-dealer or financial institution) to induce or attempt to induce the purchase or sale of any government security unless such government securities dealer is registered in accordance with Section 15C(a)(2).<sup>43</sup>

Under both the dealer and government securities dealer definitions, a person acts as a dealer or a government securities dealer when it is engaged in the business of buying and selling securities or government securities, respectively, for its own account as part of a “regular business.”<sup>44</sup>

#### Factors Considered in Evaluating “Regular Business”

Because the Exchange Act does not define what it means to be engaged in a “regular business,” courts and the Commission have looked to an array of factors in determining whether someone is a “dealer” within the meaning of the

Canada, SEC No-Action Letter (May 1, 1988); *Citicorp Homeowners, Inc.*, SEC No-Action Letter (Oct. 7, 1987); *Fairfield Trading Corp.*, SEC No-Action Letter (Dec. 10, 1987); *Continental Grain Co.*, SEC No-Action Letter (Nov. 28, 1987); *Louis Dreyfus Corp.*, SEC No-Action Letter (July 23, 1987); *United Savings Association of Texas*, SEC No-Action Letter (Apr. 2, 1987). Staff no-action letters, like all staff statements, have no legal force or effect. They do not alter or amend applicable law, and they create no new or additional obligations for any person. Upon the adoption of any final rule, some letters and other staff statements, or portions thereof, may be moot, superseded, or otherwise inconsistent with the final rules and, therefore, would be withdrawn or modified.

<sup>42</sup> The legislative history relating to the enactment of the Government Securities Act of 1986 provides that the term government securities dealer “would utilize key concepts from the current definitions of . . . ‘dealer’ and ‘municipal securities dealer.’” H.R. Rep. No. 258, 99th Cong., 1st Sess. 24 (1985). S. Rep. No. 426, 99th Cong., 2d Sess. 19 (1986).

<sup>43</sup> A government securities dealer that is a registered dealer or a financial institution must file notice with the appropriate regulatory agency that it is a government securities dealer. See 15 U.S.C. 78o-5(a). Exchange Act Section 3(a)(46) defines the term “financial institution” to include: (i) a bank (as that term is defined in Exchange Act Section 3(a)(6) (15 U.S.C. 38c(a)(6)); (ii) a foreign bank (as that term is used in the International Banking Act of 1978); and (iii) a savings association (as defined in section 3(b) of the Federal Deposit Insurance Act, the deposits of which are insured by the Federal Deposit Insurance Corporation). See 15 U.S.C. 78c(a)(46)(A) through(C).

<sup>44</sup> Unless otherwise indicated, references to “dealer” activity apply both with respect to “dealers” and “government securities dealers” under Sections 3(a)(1) and 3(a)(44) of the Exchange Act, respectively.

statute.<sup>45</sup> In determining whether a person is engaged in the business of buying and selling securities for its own account as part of a “regular business,” courts and the Commission assess the frequency with which the person buys and sells securities for its own account.<sup>46</sup> The “regularity” of participation in securities transactions necessary to find that a person is a “dealer” has not been quantified, but involves engaging in “more than a few isolated” securities transactions.<sup>47</sup>

In addition to frequency of activity, the nature of the trading activity is a factor in determining whether a person is a dealer.<sup>48</sup> Over time, the Commission has identified activities that, in context and when engaged in with regularity, may be indicative of being a dealer.<sup>49</sup> For example, the Commission has identified certain factors that would be indicators of dealer activity, including,

<sup>45</sup> See, e.g., Registration Requirements for Foreign Broker-Dealers, Exchange Act Release No. 27017 (July 11, 1989), 54 FR 30013, 30015 (July 18, 1989) (stating that the definition of “dealer” and the registration requirements under the Exchange Act “were broadly drawn by Congress to encompass a wide range of activities involving investors and the securities markets”). Recognizing that the word “business” is central to the dealer definition, courts have cited to Black’s Law Dictionary definition of business: “a commercial enterprise carried on for profit, a particular occupation or employment habitually engaged in for livelihood or gain.” *SEC v. Justin W. Keener d/b/a JM Financial*, No. 20-cv-21254, pp. 14–15 (S.D. Fla. Jan. 21, 2022) (citing *SEC v. Big Apple Consulting USA, Inc.*, 783 F.3d 786, 809 (11th Cir. 2015) which was quoting Black’s Law Dictionary 239 (10th ed. 2009)) (emphasis in original). The Eleventh Circuit elaborated that “[c]entral to this definition is profit or gain.” *Id.* (emphasis in original). See also *SEC v. Ibrahim Almagarby*, 479 F. Supp. 3d 1266, 1272 (S.D. Fla. 2020).

<sup>46</sup> See *Massachusetts Financial Services, Inc. v. Securities Investor Protection Corp.*, 411 F. Supp. 411, 415 (D. Mass.), *aff’d*, 545 F.2d 754 (1st Cir. 1976), *cert. denied*, 431 U.S. 904 (1977) (noting that the dealer definition: “connotes[s] a certain regularity of participation in securities transactions at key points in the chain of distribution.”); see also *Eastside Church of Christ v. National Plan, Inc.*, 391 F.2d at 361–362 (an entity that purchased many securities for its own account as part of its regular business and sold some of them was deemed a dealer); *SEC v. Century Inv. Transfer Corp.*, 1971 U.S. Dist. LEXIS 11364, at \*14 (S.D.N.Y. Oct. 5, 1971) (a limited partnership that bought and sold securities for its own account on numerous occasions was deemed a dealer); *SEC v. Corporate Rels. Group, Inc.*, 2003 U.S. Dist. LEXIS 24925, at \*60–61 (M.D. Fla. Mar. 28, 2003) (an unregistered stock promotion company that was operating as a broker was also operating as a dealer because it bought securities on more than a dozen occasions and sold those securities in hundreds of transactions through accounts it maintained or in which it had an interest).

<sup>47</sup> See *SEC v. Am. Inst. Counselors, Inc.*, Fed. Sec. L. Rep. (CCH) ¶ 95388 (D.D.C. 1975) (citing Loss, *Securities Regulation* (2d ed. 1961)).

<sup>48</sup> See 2002 Release at 67498.

<sup>49</sup> See *Entities Adopting Release*, 77 FR 30617 (discussing application of the dealer/trader distinction in the context of security-based swap dealers); see also 2002 Release at 67499.

among other things: (1) Acting as a market maker or specialist on an organized exchange or trading system; (2) acting as a de facto market maker or liquidity provider;<sup>50</sup> and (3) holding oneself out as buying or selling securities at a regular place of business.<sup>51</sup>

#### Trader Exclusion

The Exchange Act excludes from the definition of dealer any “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.”<sup>52</sup> While traders and dealers engage in the same core activity—buying and selling securities for their own account—their level of activity varies in absolute terms and in regularity.<sup>53</sup> The Commission has stated that dealers include those who are willing to buy and sell contemporaneously and often quickly enter into offsetting transactions to minimize the risk associated with a position.<sup>54</sup> In contrast, traders are “market participants who provide capital investment and are willing to accept the risk of ownership in listed

companies for an extended period of time,” and the Commission has stated that “it makes little sense to refer to someone as ‘investing’ in a company for a few seconds, minutes, or hours.”<sup>55</sup> The purpose of the “trader” exception is to “exclude from the definition of ‘dealer’ members of the public who buy and sell securities for their own account as ordinary traders.”<sup>56</sup>

#### B. 2010 Equity Market Structure Concept Release

The Commission raised the issue of broker-dealer registration for PTFs in its 2010 Equity Market Structure Concept Release.<sup>57</sup> Specifically, as part of its discussion relating to the potential risks to the markets posed by PTFs, the Commission requested comment on whether all PTFs should be required to register as broker-dealers.<sup>58</sup> Comments were mixed.<sup>59</sup> A number of commenters explicitly supported registration as an effective means for providing oversight

of trading activity.<sup>60</sup> Others commenters opposed registration, citing costs, burdens, and barriers to competition.<sup>61</sup>

#### C. Department of the Treasury Request for Comment

In 2016, Treasury published notice seeking public comment on the evolution of the U.S. Treasury market structure and the implications for market functions, trading and risk management practices across the U.S. Treasury market, considerations with respect to more comprehensive official sector access to U.S. Treasury market data, and the benefits and risks of increased public disclosure of U.S. Treasury market activity.<sup>62</sup> In that Request for Comment, Treasury raised the issue of registration for certain market participants, including those persons engaging in automated trading or conducting a certain volume of trading.<sup>63</sup> Specifically, concerning its continued monitoring of trading and risk management practices across the U.S. Treasury market and reviewing regulatory requirements applicable to the government securities market and its participants, Treasury requested comment on: (1) Aligning standards between U.S. securities, commodities, and derivatives markets and the U.S. Treasury cash market; (2) the implications of a registration requirement for certain market participants, including those persons engaging in automated trading or conducting a certain volume of trading; and (3) whether such firms should be subject to capital requirements, examinations and supervision, conduct rules, and/or other standards.<sup>64</sup> A number of comment letters were submitted directly or indirectly responding to these questions.<sup>65</sup> Most

<sup>50</sup> For example, a person may be acting as a dealer if they “turned a profit not from selling only after market prices increased (like a trader), but rather from quickly reselling at a marked-up price.” *River North*, 415 F. Supp. 3d at 859; see also *SEC v. Big Apple Consulting USA, Inc.*, 783 F.3d 786, 809–10 (11th Cir. 2015); *In re Sodorff*, 50 SEC. 1249, 1992 WL 224082, at \*5 (Sep. 2, 1992).

<sup>51</sup> See 2002 Release. These factors were confirmed by the Commission in 2012 when it defined certain terms, including “security-based swap dealer,” in accordance with Title VII of the Dodd-Frank Act. See *Entities Adopting Release at 30607* (distinguishing traders from dealers by noting that a trader, among other things, does not make a market). These indicia have been developed in a range of contexts over time as the markets and dealer activity have evolved, and do not represent an exclusive or exhaustive list of activities relevant for determining whether registration as a dealer is required. Further, a person not meeting the standards in the Proposed Rules may still be a dealer under otherwise applicable dealer precedent. Whether or not a person is a “dealer” is based on the facts and circumstances, where various factors are “neither exclusive, nor function as a checklist,” and meeting any one factor may be sufficient to establish dealer status. *SEC v. River North Equity LLC*, 415 F. Supp. 3d 853, 858 (N.D. Ill. 2019); accord *SEC v. Fierro*, No. 20–cv–2104, 2020 WL 7481773, at \*3 (D.N.J. Dec. 18, 2020); *SEC v. Keener*, No. 20–cv–21254, 2020 WL 4736205, at \*3–\*4 (S.D. Fla. Aug. 14, 2020); *SEC v. Almagarby*, 479 F. Supp. 3d 1266, 1272–73 (S.D. Fla. 2020); *SEC v. Bengier*, 697 F. Supp. 2d 932, 945 (N.D. Ill. 2010).

<sup>52</sup> Sections 3(a)(5)(B) and 3(a)(44)(A) of the Exchange Act.

<sup>53</sup> See *Loss*, *supra* note 40, at 720 (noting that the distinction between a trader and a dealer seeks to separate the “ordinary investor who buys and sells for his own account with some frequency” by establishing that dealers engage in the business of buying and selling securities as part of a regular business).

<sup>54</sup> 2002 Release.

<sup>55</sup> 2010 Equity Market Structure Concept Release at 3603, n. 52 (citing Regulation NMS Release, 70 FR 37500).

<sup>56</sup> See *SEC v. Am. Inst. Counselors, Inc.*, Fed. Sec. L. Rep. (CCH) ¶ 95,388 (D.D.C. 1975) (citing *Loss*, Securities Regulation (2d ed. 1961)). See also 2002 Release (“[A] person that is buying securities for its own account may still not be a ‘dealer’ because it is not ‘engaged in the business’ of buying and selling securities for its own account as part of a regular business”); *River North*, 415 F. Supp. at 859 (traders purchase securities already in the marketplace and turn a profit from selling them after they appreciate in value); *Sodorff*, 1992 WL 224082, at \*5 (same).

<sup>57</sup> See 2010 Equity Market Structure Concept Release at 3612.

<sup>58</sup> *Id.*

<sup>59</sup> See Letter from Donald R. Wilson, Jr., DRW Trading, LLC (Apr. 21, 2010); Letter from Peter Kovac, Chief Operating Officer and Financial and Operations Principal, EWT (Feb. 22, 2010); Letter from Senator Edward Kaufman (Aug. 5, 2010); Article from Stephen M. Barnes, J.D., *Regulating High-Frequency Trading: An Examination of U.S. Equity Market Structure in Light of the May 6, 2010 Flash Crash* (Dec. 2010); Letter from R.T. Leuchtkafer (Apr. 16, 2010); Letter from R.T. Leuchtkafer (July 15, 2010); Letter from Micah Hauptman, Financial Services Counsel, Consumer Federation of America (Sept. 9, 2014); Letter from Berkowitz, Trager & Trager, LLC (Apr. 21, 2010); Letter from Alston Trading, LLC, RGM Advisors, LLC, Hudson River Trading, LLC, and Quantlab Financial, LLC (Apr. 23, 2010); Letter from Marcia E. Asquith, Senior Vice President and Corporate Secretary, Financial Industry Regulatory Authority (Apr. 23, 2010); Letter from James J. Angel, Associate Professor, McDonough School of Business, Georgetown University, Lawrence E. Harris, Fred V. Keenan Chair in Finance, Professor of Finance and Business Economics, Marshall School of Business, University of Southern California, and Chester S. Spatt, Pamela R. and Kenneth B. Dunn Professor of Finance, Director, Center for Financial Markets, Tepper School of Business, Carnegie Mellon University, Equity Trading in the 21st Century (Feb. 23, 2010); and Letter from Kurt N. Schacht, Managing Director and Linda L. Rittenhouse, Director, Capital Markets Policy, CFA Institute (June 22, 2010).

<sup>60</sup> See Letter from Peter Kovac, Chief Operating Officer and Financial and Operations Principal, EWT (Feb. 22, 2010); Letter from Senator Edward Kaufman (Aug. 5, 2010); Article from Stephen M. Barnes, J.D., *Regulating High-Frequency Trading: An Examination of U.S. Equity Market Structure in Light of the May 6, 2010 Flash Crash* (Dec. 2010); Letter from R.T. Leuchtkafer (Apr. 16, 2010); Letter from R.T. Leuchtkafer (July 15, 2010); Letter from Micah Hauptman, Financial Services Counsel, Consumer Federation of America (Sept. 9, 2014). See also Letter from Donald R. Wilson, Jr., DRW Trading, LLC (Apr. 21, 2010), pp 3–4 (supporting registration only for those firms that engage in high-volume and high-speed trading).

<sup>61</sup> See Letter from Berkowitz, Trager & Trager, LLC (Apr. 21, 2010); Letter from Alston Trading, LLC, RGM Advisors, LLC, Hudson River Trading, LLC, and Quantlab Financial, LLC (Apr. 23, 2010).

<sup>62</sup> See Treasury Request for Comment.

<sup>63</sup> See Treasury Request for Comment at 3930.

<sup>64</sup> See Treasury Request for Comment at 3931 (Questions 2.6, 2.6(a) and 2.6(b)).

<sup>65</sup> See Letter from Deirdre K. Dunn, Managing Director—Head of NA G10 Rates, Citi Global

commenters explicitly supported consistent regulatory standards to be applied to certain market participants, including those persons engaging in automated trading or conducting a certain volume of trading,<sup>66</sup> with some commenters explicitly supporting the registration of market participants that are not currently registered as dealers.<sup>67</sup> One commenter was opposed to the registration of certain market participants citing disapproval of the “application of arbitrary thresholds when determining the applicability of regulation.”<sup>68</sup> Another commenter stated that “principal trading firms have played an increasingly larger role in offering liquidity in these markets, and have become de facto market makers.”<sup>69</sup>

#### D. Need for Commission Action

While the participation of these PTFs and other significant market participants that are not registered as dealers may have positive effects, such as through increased competition, there are risks that accompany such market participants’ trading activities and the

Markets (Apr. 22, 2016) (“Citi Global”); Letter from Shane O’Cuinn, Managing Director, Credit Suisse/Global Markets (Apr. 22, 2016) (“Credit Suisse”); Letter from Joanna Mallers, Secretary, FIA Principal Traders Group (Apr. 22, 2016) (“FIA PTG”); Comment from Kermit Kubitz (Apr. 22, 2016); Letter from William Harts, Modern Market Initiative (Apr. 22, 2016) (“MMI”); Letter from Prudential Fixed Income (Apr. 21, 2016) (“Prudential”); Letter from Alan Mittleman, Managing Director, Head of USD Rates Trading, RBS Securities Inc. (Apr. 22, 2016) (“RBS Securities”); Letter from Reserve Bank of India (Apr. 22, 2016); Letter from Mike Zolik, Nate Kalich, and Larry Magargal, Ronin Capital, LLC (Mar. 19, 2016) (“Ronin Capital”); Letter from Timothy W. Cameron, Esq., Asset Management Group—Head and Lindsey Weber Keljo, Vice President and Assistant General Counsel, Asset Management Group, Securities Industry and Financial Markets Association (Apr. 22, 2016) (“SIFMA–AMG”); Letter from Greg Moore, Managing Director and Head of FICM New York, TD Securities (USA) LLC (Apr. 22, 2016) (“TD Securities”); and Letter from C. Thomas Richardson, Managing Director, Head of Market Structure, Head of Electronic Trading Services, and Cronin McTigue, Managing Director, Head of Liquid Products, Wells Fargo Securities (Apr. 21, 2016) (“Wells Fargo”).

<sup>66</sup> See Letter from Citi Global; Letter from Credit Suisse; Comment from Kermit Kubitz; Letter from MMI; Letter from Prudential; Letter from RBS Securities; Letter from Reserve Bank of India; Letter from Ronin Capital; Letter from SIFMA–AMG; Letter from TD Securities; and Letter from Wells Fargo.

<sup>67</sup> See Letter from Prudential; Letter from MMI; Letter from TD Securities; Letter from Reserve Bank of India; Letter Citi Global; and Letter from Ronin Capital.

<sup>68</sup> See Letter from FIA PTG.

<sup>69</sup> See Letter from Stuart Kaswell, Executive Vice President and Managing Director, General Counsel, and Jiri Król, Deputy CEO, Global Head of Government Affairs, Alternative Investment Management Association (Apr. 22, 2016) at 2 (describing the evolution of market structure generally).

accompanying lack of regulatory obligations or oversight relating to such activity.<sup>70</sup> Among other things, scrutiny of the U.S. Treasury market, in light of recent market disruptions,<sup>71</sup> has identified a regulatory gap in terms of the registration status and regulation of significant market participants in the U.S. Treasury market. Not only does such a regulatory gap mean inconsistent oversight of market participants performing similar functions either in the same market or across asset classes but, as described below, the activity of significant market participants that are not registered may pose certain risks to the markets.

In particular, certain market participants, such as PTFs that are not registered as dealers, play an increasingly significant role as major liquidity providers across asset classes in the U.S. securities markets, including the U.S. Treasury market. These market participants engage in a significant volume of trading across many trading platforms for their own accounts, generally ending the day with a relatively small position. In the U.S. Treasury market, in particular, market commenters and financial regulators have stated that the rise of electronic trading and emergence of unregulated significant market participants over the years could be a contributing factor to the more frequent market disruptions, specifically stating that these changes are directly affecting liquidity provision.<sup>72</sup>

The Commission believes that, although the Proposed Rules will not by themselves necessarily prevent future market disruptions, the operation of the rules will support transparency; market integrity and resiliency; and investor protection; across the U.S. Treasury and other securities markets by closing the regulatory gap that currently exists and ensuring consistent regulatory oversight of persons engaging in the type of activities described in the Proposed Rules.<sup>73</sup> The requirement that dealers register has been repeatedly recognized as being “of the utmost importance in effecting the purposes of the [Exchange] Act. It is through the registration requirement that some discipline may be exercised over those who may engage in the securities business and by which necessary standards may be established

<sup>70</sup> See Section V for discussion of competition; see also Algorithmic Trading Staff Report.

<sup>71</sup> See 2021 IAWG Report.

<sup>72</sup> See 2021 IAWG Joint Staff Report (stating that the October 15, 2014 market disruption made clear that, among other things, “electronic trading permitted rapid increases in orders that removed liquidity”) at 18, and G30 Report.

<sup>73</sup> See Section V.

with respect to training, experience, and records.”<sup>74</sup> For example, as described below in Section V.C, dealers and government securities dealers must register with the Commission and become members of a self-regulatory organization (“SRO”);<sup>75</sup> comply with Commission and SRO rules, including certain financial responsibility and risk management rules,<sup>76</sup> transaction and

<sup>74</sup> *River North*, 415 F. Supp. 3d 853, 858 (citing *Benger*, 697 F. Supp. 2d at 944 (quoting *Celsion Corp. v. Stearns Mgmt. Corp.*, 157 F. Supp. 2d 942, 947 (N.D. Ill. 2001)); see also *Roth v. SEC*, 22 F.3d 1108, 1109 (D.C. Cir. 1994) (“The broker-dealer registration requirement serves as the keystone of the entire system of broker-dealer regulation.”); see Section 15(b)(7) of the Exchange Act, 15 U.S.C. 78o(b)(7), and 17 CFR 240.15b7–1 (Rule 15b7–1 thereunder) (requiring natural persons associated with a broker-dealer to be registered or approved “in accordance with the standards of training, experience, competence, and other qualification standards”); see also Financial Industry Regulatory Authority (“FINRA”) Rule 1210 (Registration Requirements) and FINRA Rule 1220 (Registration Categories), which require, for example, an associated person of a member broker-dealer of FINRA who is primarily responsible for the design, development, or significant modification of an algorithmic trading strategy, or who is responsible for supervising or directing such activities, to pass the Series 57 exam, register as a Securities Trader, and comply with continuing education requirements.

<sup>75</sup> See Sections 15(b)(8), 15C(e)(1), and 17(b) of the Exchange Act, 15 U.S.C. 78o(b)(8), 15 U.S.C. 78o–5(e)(1), and 15 U.S.C. 78q(b), respectively. Section 15(b)(8) of the Exchange Act makes it unlawful for any registered broker or dealer to effect any transaction in securities (with certain exceptions) unless the broker or dealer is a member of a registered securities association or effects transactions in securities solely on a national securities exchange of which it is a member. Section 15C(e)(1) of the Exchange Act requires that a registered government securities broker-dealer, other than certain financial institutions, become a member of a registered national securities exchange or registered national securities association. Because government securities are not traded on registered national securities exchanges, a person that registers as a government securities dealer under Section 15C to trade only government securities would need to become a member of a registered national securities association (FINRA is the only registered national securities association). Currently, however, a person that is engaged in a regular business of buying and selling both government securities and other securities for its own account, and therefore registers as a dealer under Section 15, could potentially be exempt from Section 15(b)(8)’s national securities association membership requirement if it is or becomes a member of a national securities exchange and satisfies other requirements. See 17 CFR 240.15b9–1. Section 17(b) of the Exchange Act provides, among other things, that all records of a broker-dealer are subject at any time, or from time to time, to such reasonable, periodic, special, or other examinations by representatives of the Commission and the appropriate regulatory agency of the broker-dealer as the Commission or the appropriate regulatory agency deems necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Exchange Act.

<sup>76</sup> See, e.g., 17 CFR 240.15c3–1 (Exchange Act Rule 15c3–1) (the “Net Capital Rule”); Financial Responsibility Rules for Broker-Dealers, Exchange Act Release No. 70072 (July 30, 2013), 78 FR 51823 at 51849 (Aug. 21, 2013) (“The capital standard in

other reporting requirements,<sup>77</sup> operational integrity rules,<sup>78</sup> and books and records requirements,<sup>79</sup> all of which

Rule 15c3-1 is a net liquid assets test. This standard is designed to allow a broker-dealer the flexibility to engage in activities that are part of conducting a securities business (e.g., taking securities into inventory) but in a manner that places the firm in the position of holding at all times more than one dollar of highly liquid assets for each dollar of unsubordinated liabilities (e.g., money owed to customers, counterparties, and creditors). The rule imposes a “moment to moment” net capital requirement in that broker-dealers must maintain an amount of net capital that meets or exceeds their minimal net capital requirement at all times.

<sup>77</sup> See, e.g., FINRA Rule 6730(a)(1) (requiring FINRA members to report transactions in TRACE-Eligible Securities, including Treasury securities, which promotes transparency to the securities markets, including the Treasury market, by providing market participants with comprehensive access to transaction data); FINRA Rule 7200 (Trade Reporting Facilities); FINRA Rule 4530 (Reporting Requirements) which requires FINRA members to report among other things when the member or an associated person of the members has violated certain specified regulatory requirements, is subject to written customer complaint, and is denied registration or is expelled, enjoined, directed to cease and desist, suspended or disciplined by a specified regulatory body. The provision at 17 CFR 240.17a-5(d)(1)(i)(A) (Exchange Act Rule 17a-5(d)(1)(i)(A)) requires broker-dealers, subject to limited exceptions, to file annual reports, including financial statements and supporting schedules that generally must be audited by a Public Company Accounting Oversight Board (PCAOB)-registered independent public accountant in accordance with PCAOB standards.

<sup>78</sup> 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.

<sup>79</sup> See, e.g., Section 17(a) of the Exchange Act and 17 CFR 240.17a-3 and 240.17a-4 (Rules 17a-3 and 17a-4 thereunder); see also, e.g., FINRA Rules 2268, 4510, 4511, 4512, 4513, 4514, 4515, 5340 and 7440(a)(4) (requiring member firms to make and preserve certain books and records to show compliance with applicable securities laws, rules, and regulations and enable Commission and FINRA staffs to conduct effective examinations); NYSE Rule 440 (Books and Records); CBOE Exchange Rule 7.1 (Maintenance, Retention and Furnishing of Books, Records and Other Information). Among other things, Commission and SRO books and records rules help to ensure that regulators can access information to evaluate the financial and operational condition of the firm, including examining compliance with financial responsibility rules, among other rules, as well as assess whether and how a firm’s participation in the securities markets impacted a major market event. See Staff Study on Investment Advisers and Broker-Dealers As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Jan. 2011) at 72. See also Recordkeeping and Reporting Requirements for Security-Based Swap Dealers, Major Security-Based Swap Participants, and Broker-Dealers; Capital Rule for Certain Security-Based Swaps Dealers, Exchange Act Release No. 71958 (Apr. 17, 2014), 79 FR 25194, 25199 (May 2, 2014) (“The requirements are an integral part of the investor protection function of the Commission, and other securities regulators, in that the preserved records are the primary means of monitoring compliance with applicable securities laws,

help to enhance market stability by giving regulators increased insight into firm-level and aggregate trading activity and so help regulators to evaluate, assess, and address, as appropriate, market risks. In addition, registered dealers and government securities dealers are required to comply with specific anti-manipulative and other anti-fraud rules that are promulgated pursuant to Section 15(c) of the Exchange Act, thereby contributing to fair and orderly markets.<sup>80</sup> Firms that are government securities dealers (including registered broker-dealers trading government securities) must also comply with rules adopted by Treasury, including but not limited to rules relating to financial responsibility, recordkeeping, financial condition reporting, risk oversight, and large trader reporting.<sup>81</sup> Importantly, dealers and government securities dealers are subject to Commission and SRO examination, inspection, and enforcement for compliance with applicable Federal securities laws and SRO rules.<sup>82</sup>

including antifraud provisions and financial responsibility standards.”)

<sup>80</sup> See, e.g., Sections 15(c)(1) and (2) of the Exchange Act, 15 U.S.C. 78o(c)(1) and (2), and rules promulgated thereunder.

<sup>81</sup> Under Title I of the Government Securities Act (“GSA”), all government securities brokers and government securities dealers are required to comply with the requirements in Treasury’s GSA regulations that are set out in 17 CFR parts 400 through 449. For the most part, Treasury’s GSA regulations incorporate with some modifications: (1) Commission rules for non-financial institution government securities brokers and government securities dealers; and (2) the appropriate regulatory agency rules for financial institutions that are required to file notice as government securities brokers and government securities dealers. See, e.g., 17 CFR part 400, Rules of general application; 17 CFR part 401, Exemptions; 17 CFR part 402, Financial responsibility; 17 CFR part 403, Protection of customer securities and balances; 17 CFR part 404, Recordkeeping and preservation of records; 17 CFR part 405, Reports and audit; 17 CFR part 420, Large position reporting; and 17 CFR part 449, Forms, Section 15C of the Exchange Act. The GSA regulations also include requirements for custodial holdings by depository institutions at 17 CFR part 450, which were issued under Title II of the GSA. The Treasury GSA regulations provide in many instances that a registered dealer can comply with a Commission rule to establish compliance with the comparable Treasury requirement. See, e.g., 17 CFR 402.1(b) (Treas. Reg. § 402.1(b)) (“This part does not apply to a registered broker or dealer . . . that is subject to [Exchange Act Rule 15c3-1.]”); 17 CFR 403.1 (Treas. Reg. § 403.1) (regarding application to registered brokers or dealers); 17 CFR 404.1 and 405.1(a) (Treas. Reg. §§ 404.1 and 405.1(a)) (same).

<sup>82</sup> See Exchange Act Section 15(b) (regarding Commission authority to sanction brokers and dealers); Section 15C(c) (regarding Commission authority to sanction government securities dealers that are registered with it); Section 15C(d) (authorizing the Commission to examine books and records of government securities dealers registered with it); and Section 17(b) (broker-dealer recordkeeping and examination). See also Section

### III. Overview of Proposed Rules

The operative concept in the definitions of “dealer” and “government securities dealer”—that distinguishes the regulated entity from the unregulated trader—is that the dealer is engaged in buying and selling securities for its own account “as part of a regular business.”<sup>83</sup> The Commission is proposing two rules—proposed Rules 3a5-4 and 3a44-2—to further define these terms to identify certain activities that would constitute a “regular business” requiring a person engaged in those activities to register as a “dealer” or a “government securities dealer,” absent an exception or exemption.<sup>84</sup> A person (as defined below) who engages in any one of the activities identified in either proposed Rule 3a5-4 or 3a44-2 would be considered a dealer under that rule.<sup>85</sup>

As explained above, over the years the Commission and the courts have identified a number of qualitative factors, including acting as a market maker, de facto market maker, or liquidity provider, that might indicate a person may be engaged in a regular business of buying and selling securities for its own account.<sup>86</sup> The Proposed Rules would expand upon these statements to further define three qualitative standards designed to more specifically identify activities of certain market participants who assume dealer-like roles, specifically, persons whose trading activity in the market “has the effect of providing liquidity” to other

15C(g) (restricting the ability of the Commission with respect to government securities dealers that are not registered with the Commission).

<sup>83</sup> As discussed above, the definitions of “dealer” and “government securities dealer” under the Exchange Act exclude from dealer status a person that buys or sells securities for such person’s own account “but not as a part of a regular business.” See 15 U.S.C. 78c(a)(5)(A) and (B) and 15 U.S.C. 78c(a)(4)(A).

<sup>84</sup> See Exchange Act Section 15 (regarding registration of dealers) and Section 15C (regarding registration of government securities dealers).

<sup>85</sup> Status as a securities “dealer” or “government securities dealer” as a result of engaging in securities or government securities transactions “as part of a regular business” under proposed Rules 3a5-4 or 3a44-2 is not determinative of a person’s status for purposes of the exclusions in Section 3(c)(2) of the Investment Company Act. Although that exclusion uses some terminology that is similar to that in the Proposed Rules, Section 3(c)(2) includes a number of conditions in addition to the requirement that a person regularly engage in transactions on both sides of the market, each of which an entity would have to satisfy to be able to rely on the investment company exclusion.

<sup>86</sup> See 2002 Release (stating that a person generally may satisfy the definition, and therefore, be acting as a dealer in the securities markets, by conducting various activities, including “acting as a market maker or specialist on an organized exchange or trading system” or “acting as a *de facto* market maker whereby market professionals or the public look to the firm for liquidity”).

market participants.<sup>87</sup> While all market participants who buy or sell securities in the marketplace arguably contribute to a market's liquidity, the Proposed Rules focus on market participants who engage in a routine pattern of buying and selling securities for their own account that has the effect of providing liquidity. Said differently, for market participants engaging in any of the activities identified by the qualitative standards of the Proposed Rules, liquidity provision is not incidental to their trading activities. Rather, these persons are "in the business" of buying and selling securities for their own account and providing liquidity as part of a regular business.<sup>88</sup> The Proposed Rules would set forth three standards that the Commission believes would appropriately distinguish and identify such liquidity provision as a "regular business."

In addition, proposed Rule 3a44-2, which would apply only to government securities dealers, would include a quantitative standard.<sup>89</sup> This quantitative standard would establish a bright-line test, under which a person engaging in certain specified levels of activity would be deemed to be buying and selling government securities "as a part of a regular business," regardless of whether it meets any of the qualitative standards.<sup>90</sup>

A person whose activity meets the quantitative or any of the qualitative standards would be a dealer and so subject to the Exchange Act registration requirements, regardless of whether the

liquidity provision is a chosen consequence of its activities.<sup>91</sup>

To account for variations in corporate structure and ownership, the Proposed Rules additionally would define the terms "own account" and "control." The Proposed Rules would define a person's "own account" to mean, subject to certain exceptions, any account: (i) Held in the name of that person; (ii) held in the name of a person, over whom that person exercises control or with whom that person is under common control;<sup>92</sup> or (iii) held for the benefit of those persons identified in (i) and (ii). In addition, the Proposed Rules would give "control" the "same meaning as prescribed in § 240.13h-1 (Rule 13h-1), under the Exchange Act."

While the Proposed Rules would establish standards that identify when a person is acting as a dealer or government securities dealer, whether a person's activities meet these standards would remain a facts and circumstances determination.<sup>93</sup> Importantly, the Proposed Rules are not the exclusive means of establishing that a person is a dealer or government securities dealer—to the extent consistent with the Proposed Rules, existing Commission interpretations and precedent will continue to apply.<sup>94</sup>

A market participant that is not registered as a dealer that comes within

the scope of the Proposed Rules would need to register with the Commission as a dealer or government securities dealer and become a member of an SRO. This would involve filing Form BD with the Commission and completing the SRO's processes for new members.<sup>95</sup> The Commission is proposing to provide such market participants a one-year compliance period from the effective date of any final rules. The proposed compliance period is designed to provide adequate time for persons captured by the Proposed Rules at the time of adoption, if adopted, to apply for dealer registration, and for the relevant SROs to conduct their review of the new member applications, without disrupting the markets or the participants' market activities. The proposed compliance period would not cover market participants whose activities following the effective date of any final rules require registration as dealers under those rules.

#### A. Persons Excluded From the Proposed Rules

Under the Proposed Rules, the term "person" would have the same meaning as prescribed in Section 3(a)(9) of the Exchange Act.<sup>96</sup> As a threshold matter, the Proposed Rules would not apply to: (i) "[a] person that has or controls total assets of less than \$50 million;"<sup>97</sup> or (ii) "[an] investment company registered under the Investment Company Act."<sup>98</sup>

As discussed above, the Proposed Rules are intended to capture market participants not registered as dealers that serve a critical dealer-like role in the securities and government securities markets through their liquidity provision or significant and regular trading activity in the market. By providing an exception for persons that have or control total assets of less than \$50 million, the Proposed Rules would parallel an established standard for distinguishing between "retail" and "institutional" investors in other

<sup>95</sup> After receiving a substantially complete application package, FINRA, for instance, must review and process it within 180 calendar days. See "How to Become a Member—Member Application Time Frames," available at <https://www.finra.org/registration-exams-ce/broker-dealers/how-become-member-membership-application-time-frames>. See also FINRA Rule 1014.

<sup>96</sup> See proposed Rule 3a5-4(b)(1) and proposed Rule 3a44-2(b)(1).

<sup>97</sup> See proposed Rule 3a5-4(a)(2)(i) and proposed Rule 3a44-2(a)(3)(i). While a person who has or controls less than \$50 million in total assets would not be subject to the Proposed Rules, that person's trading volume or activities may still be aggregated with those of another person under the Proposed Rules definitions of "own account" and "control." See Section III.D.

<sup>98</sup> See proposed Rule 3a5-4(a)(2)(ii) and proposed Rule 3a44-2(a)(3)(ii).

<sup>87</sup> As noted below, the Proposed Rules are not the exclusive means of establishing that a person is a dealer or government securities dealer—to the extent consistent with the Proposed Rules, existing Commission interpretations and precedent will continue to apply. See above Section II.A. For example, facts indicating a person may be acting as a "dealer" include underwriting, as well as buying and selling directly to securities customers together with conducting any of an assortment of professional market activities such as providing investment recommendations, extending credit, and lending securities in connection with transactions in securities, and carrying a securities account. See 2002 Release. See also *SEC v. Justin W. Keener d/ b/a JMJ Financial*, No. 20-cv-21254 (S.D. Fla. Jan. 21, 2022). Accordingly, a person may still be acting as a dealer even if they do not, under the Proposed Rules, engage in a routine pattern of buying and selling securities that has the effect of providing liquidity to other market participants. See proposed Rule 3a5-4(c) and proposed Rule 3a44-2(c), discussed below in Section III.E.

<sup>88</sup> PTFs engaging in passive market making, for example, earn revenue primarily from the provision of liquidity, specifically "by buying at the bid and selling at the offer and capturing any liquidity rebates offered by trading centers to liquidity supplying orders." See, e.g., 2010 Equity Market Structure Concept Release at 3607.

<sup>89</sup> See Section III.C.

<sup>90</sup> See *id.*

<sup>91</sup> The Proposed Rules focus on effect regardless of a person's intention. The fact that the provision of liquidity is a fundamental aspect of the activities captured by the qualitative standards does not mean that such liquidity provision need be deliberate to come within the Proposed Rules. Intent is not required by the statutory language, nor is it relevant in every circumstance.

<sup>92</sup> The Proposed Rules would exclude from aggregation under paragraph (b)(2)(ii): (A) An account in the name of a registered broker, dealer, government securities dealer, or an investment company registered under the Investment Company Act; (B) with respect to an investment adviser registered under the Advisers Act, an account held in the name of a client of the adviser unless the adviser controls the client as a result of the adviser's right to vote or direct the vote of voting securities of the client, the adviser's right to sell or direct the sale of voting securities of the client, or the adviser's capital contributions to or rights to amounts upon dissolution of the client; or (C) with respect to any person, an account in the name of another person that is under common control with that person solely because both persons are clients of an investment adviser registered under the Advisers Act unless those accounts constitute a parallel account structure.

<sup>93</sup> Cf. 2002 Release ("[T]he analysis of whether a person meets the definition of a dealer depends upon all of the relevant facts and circumstances.").

<sup>94</sup> See Section II.A. For example, a person generally may satisfy the statutory definition of "dealer" by underwriting, or buying and selling directly to securities customers together with conducting any of an assortment of professional market activities such as providing investment recommendations, extending credit, and lending securities in connection with transactions in securities, and carrying a securities account. See 2002 Release.

contexts.<sup>99</sup> The Commission believes that this threshold is appropriate in the context of the Proposed Rules because, even though a person that has or controls less than \$50 million in assets may be engaged in the activities identified in the Proposed Rules' qualitative standards,<sup>100</sup> the frequency and nature of its securities trading are less likely to pose the types of financial and operational risks to the market that may be associated with the significant dealer-like activity engaged in by certain PTFs and other institutional market participants, that the Proposed Rules are designed to address.<sup>101</sup> This is not an exclusion from the dealer definition for all purposes. Rather, as with other persons not within the ambit of the Proposed Rules, the question of whether a person that has or controls less than \$50 million in total assets is acting as a dealer, as opposed to a trader, will remain a facts and circumstances determination, and to the extent consistent with the Proposed Rules, existing applicable interpretations and precedent will continue to apply.<sup>102</sup>

<sup>99</sup> Under FINRA rules, a "retail" account is distinguished from an "institutional" account by defining, in part, an institutional account as belonging to "a person (whether a natural person, corporation, partnership, trust, or otherwise) with total assets of at least \$50 million." FINRA Rule 4512(c)(3); *see also* Business Conduct Standards for Security-Based Swap Dealers and Major Security-Based Swap Participants, Exchange Act Release No. 77617 (Apr. 14, 2016), 81 FR 29959, 29995 n.462 (May 13, 2016) (adopting a similar threshold for purposes of 17 CFR 240.15Fh-3(f)(4) (Exchange Act Rule 15Fh-3(f)(4))). The Proposed Rules do not use the definition of "retail customer" adopted as part of Regulation Best Interest, as the policy considerations behind that definition are different than those presented here: The focus of Regulation Best Interest is the regulatory protections provided to customers who receive recommendations from broker-dealers, whereas the focus of this proposed rulemaking is the regulation of persons engaging in certain dealer-like activities. *See* Regulation Best Interest: The Broker-Dealer Standard of Conduct, Exchange Act Release No. 86031 (June 5, 2019), 84 FR 33318 (July 12, 2019).

<sup>100</sup> As discussed in Section III.C, to meet the quantitative standard set forth in proposed Rule 3a44-2(a)(2) a person must, in each of four out of the last six calendar months, engage in buying and selling more than \$25 billion of trading volume in government securities as defined in Section 3(a)(42)(A) of the Exchange Act. The Commission believes that there will not be any instances where a person who has or controls less than \$50 million in total assets will meet this quantitative standard.

<sup>101</sup> Depending on the scope and nature of its activities, such a person could come within the definition of "pattern day trader" under FINRA rules. *See* FINRA Rule 4210. Notably, among other requirements, a pattern day trader must maintain a minimum amount of equity in its margin account on any day that the customer day trades and this minimum equity must be in the account prior to engaging in any day-trading activities. *Id.* If the account falls below the minimum requirement, the pattern day trader will not be permitted to day trade until the account is restored to the minimum equity level. *Id.*

<sup>102</sup> As discussed above, dealer status involves engaging in "more than a few isolated" securities

The Commission is proposing to exclude registered investment companies from the application of the Proposed Rules.<sup>103</sup> Registered investment companies are subject to a regulatory framework under the Investment Company Act and rules thereunder, which imposes requirements regarding capital structure,<sup>104</sup> custody of assets,<sup>105</sup> investment activities,<sup>106</sup> transactions with affiliates and other conflicts of interest,<sup>107</sup> and the duties and independence of boards of directors, among other things.<sup>108</sup> Moreover, registered investment companies are subject to statutory limits on indebtedness and rules that limit leverage risk.<sup>109</sup> In addition, registered investment companies must adopt, implement, and review at least annually written policies and procedures reasonably designed to prevent violations of the Federal securities laws by the fund.<sup>110</sup> These policies and procedures must be approved by the

transactions. *See supra* note 47 and accompanying text.

<sup>103</sup> A registered investment company includes any issuer which is or holds itself out as being primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities. 15 U.S.C. 80a-3(a)(1)(A). The Investment Company Act generally prohibits a domestic registered investment company from offering or selling any security unless the company is registered under Section 8 of the Investment Company Act. 15 U.S.C. 80a-7(a).

<sup>104</sup> *See* 15 U.S.C. 80a-18.

<sup>105</sup> *See* 15 U.S.C. 80a-17(f); 17 CFR 270.17f-1 through 270.17f-7.

<sup>106</sup> *See, e.g.,* 15 U.S.C. 80a-12(d)(1), 12(d)(3).

<sup>107</sup> *See* 15 U.S.C. 80a-17(a), (d), (e); 17 CFR 270.17d-1, 270.17e-1.

<sup>108</sup> *See, e.g.,* 15 U.S.C. 80a-2(a)(41), 15, 17(f), 17 CFR 270.17(j), 270.31(a); 17 CFR 270.2a-4, 270.2a-5, 270.10f-3, 270.12b-1, 270.17a-7, 270.17e-1, 270.22c-1, 270.38a-1.

<sup>109</sup> *See* 15 U.S.C. 80a-18 (Section 18 prohibits closed-end funds from issuing or selling senior securities that represent indebtedness unless it has at least 300 percent asset coverage, and open-end funds from issuing or selling a senior security other than borrowing from a bank, also subject to 300 percent asset coverage and defines "senior security," in part, as "any bond, debenture, note, or similar obligation or instrument constituting a security and evidencing indebtedness."); 17 CFR 270.18f-4 (generally requiring investment companies that use derivatives to adopt a derivatives risk management program that includes a limitation on leverage risk based on Value-at-Risk (VaR)). *See also* Use of Derivatives by Registered Investment Companies and Business Development Companies, Investment Company Act Release No. 34084 (Nov. 2, 2021), 85 FR 83162 (Dec. 21, 2020).

<sup>110</sup> 17 CFR 270.38a-1. The fund's policies and procedures also must provide for the oversight of compliance by the fund's advisers, principal underwriters, administrators, and transfer agents. *See also* 15 U.S.C. 80a-47(a) ("It shall be unlawful for any person, directly or indirectly, to cause to be done any act or thing through or by means of any other person which it would be unlawful for such person to do under the provisions of this subchapter or any rule, regulation, or order thereunder.").

fund's board of directors, including a majority of independent directors, and are administered by a designated chief compliance officer.<sup>111</sup> Registered investment companies are required to register under the Investment Company Act and offer their shares under the Securities Act of 1933 ("Securities Act").<sup>112</sup> They also must report to the Commission on many aspects of their operations and their portfolio holdings.<sup>113</sup> Registered investment companies must maintain certain books and records and make them available for examination by the Commission.<sup>114</sup> As a result, the Commission has extensive oversight of registered investment companies and broad insight into their operations and activities. In light of the regulatory structure that governs registered investment companies, which addresses, among other things, the types of concerns that we seek to address in the Proposed Rules, the Commission is proposing to exclude registered investment companies from the application of the Proposed Rules.<sup>115</sup>

The Proposed Rules would not exclude private funds because we are taking a similar approach to regulating dealer activity across market participants and, unlike registered investment companies, private funds are not subject to the extensive regulatory framework of the Investment Company Act. The Commission is mindful that registered private fund advisers are regulated under the Advisers Act and that information on private fund activities is reported by registered

<sup>111</sup> 17 CFR 270.38a-1.

<sup>112</sup> Depending on the organizational form, investment companies register under the Investment Company Act and offer their shares under the Securities Act on Forms N-1A (open-end management investment companies), N-2 (closed-end management investment companies), N-3 (separate accounts organized as management companies), N-4 (separate accounts organized as unit investment trusts), N-5 (small business investment companies), and N-6 (separate accounts organized as unit investment trusts that offer variable life insurance products).

<sup>113</sup> Registered investment companies report certain census information annually to the Commission on Form N-CEN. Registered investment companies also are required to report monthly portfolio-wide and position-level holdings data to the Commission on Form N-PORT. This includes information regarding repurchase agreements, securities lending activities, and counterparty exposures, terms of derivatives contracts, and discrete portfolio level and position level risk measures to better understand fund exposure to changes in market conditions.

<sup>114</sup> 15 U.S.C. 80a-30.

<sup>115</sup> As discussed in Section III.D, for purposes of the definition of "own account," an account held in the name of a person that is a registered investment company would not be attributed to a controlling person or another person under common control.

private fund advisers on Form PF.<sup>116</sup> The information the Commission obtains on private funds through its regulation of registered investment advisers, however, differs from that the Commission collects for the purposes of dealer regulation. In addition, dealer registration enhances regulatory oversight of market participants' trading activities and interactions with the market overall and dealer regulatory requirements focus broadly on market functionality (along with protecting investors under principles of fair dealing between parties).

Similarly, the Proposed Rules would not apply a blanket exclusion for registered investment advisers. A registered investment adviser trading for its "own account" as defined in the Proposed Rules could implicate dealer registration requirements.<sup>117</sup> The Commission is mindful, however, that with some clients, a registered investment adviser only exercises investment discretion over the client's account, while with some other clients, the adviser also may control the client through an ownership interest. The Proposed Rules take into account a registered investment adviser's role in determining what client trading activity should be attributed to the adviser for purpose of the rules.<sup>118</sup>

#### Request for Comments

The Commission generally requests comment on this aspect of the Proposed Rules. In addition, the Commission requests comment on the following specific issues:

1. Should the Proposed Rules exclude persons that have or control less than \$50 million in total assets? Are there instances in which persons that have or control less than \$50 million in total assets that are buying and selling securities or government securities for their own accounts provide liquidity to the markets or have a significant impact on the markets that would warrant

<sup>116</sup> The Commission recently has issued a proposal to amend Form PF, which would provide the SEC and the Financial Stability Oversight Counsel ("FSOC") with additional confidential information about private funds. Information reported on Form PF has helped establish a baseline picture of the private fund industry for use in assessing systemic risk. These proposed amendments would apply to large hedge fund advisers, private equity advisers, and large liquidity fund advisers and are designed to enhance FSOC's and the Commission's ability to monitor systemic risk, bolster the Commission's regulatory oversight of private fund advisers, and enhance investor protection efforts. See Form PF Proposing Release, *supra* note 34.

<sup>117</sup> See proposed Rule 3a5-2(b)(2) and proposed Rule 3a44-2(b)(2).

<sup>118</sup> See *infra* note 185 and accompanying text.

regulation as dealers or government securities dealers? Please explain.

2. Does the proposed \$50 million in total assets threshold sufficiently distinguish persons whose activity should not be captured for purposes of the Proposed Rules? If not, is there another amount or measurement that would better distinguish these smaller market participants and achieve the purposes of the Proposed Rules? Please explain.

3. Would persons that would be captured by the Proposed Rules (*i.e.*, have or control more than \$50 million in total assets) restructure their activities or change their corporate structures for the purpose of avoiding registration, including withdrawing or reducing their trading activities or ceasing investment strategies that trigger the application of the Proposed Rules? What would be the effects of such restructuring, withdrawal, or cessation? Please explain.

4. Should the Commission exclude registered investment companies from the scope of the Proposed Rules? Why or why not? If they are not excluded, do registered investment companies engage in activities that would be captured by the Proposed Rules? Could a registered investment company comply with the requirements applicable to dealers? What would be the potential costs and/or benefits of requiring registered investment companies to register as dealers or government securities dealers? Could the registered investment companies restructure their activities to avoid dealer registration? What would be the effects of such restructuring? Please explain.

5. The Proposed Rules do not exclude private funds, that is, pooled investment vehicles that are exempted from the definition of "investment company" under Section 3(c)(1) or 3(c)(7) of the Investment Company Act. Should the Commission except or exclude private funds from the scope of the Proposed Rules? Why or why not? Should the Commission except or exclude private funds advised by registered investment advisers from the scope of the Proposed Rules? Do some private funds engage in activities that would be captured by the Proposed Rules? Could a private fund comply with the requirements applicable to dealers? What would be the potential costs and/or benefits of requiring private funds to register as dealers or government securities dealers? Would private funds restructure their activities to avoid registration as a dealer? What would be the effects of such restructuring? Would private funds cease or reduce investment strategies captured by the

Proposed Rules to avoid registration as a dealer? If so, what would be the effects of removing or reducing these investment strategies from the markets? Please explain.

6. Should registered investment advisers trading for their own accounts be excluded partially or entirely from the Proposed Rules? Why or why not? Could some registered investment advisers engage in activities that meet the proposed qualitative standards and trigger the application of the Proposed Rules? Could some registered investment advisers engage in trading volume in government securities that could exceed the quantitative threshold in proposed Rule 3a44-2? If registered investment advisers were captured by the Proposed Rules, how would they comply with the requirements applicable to dealers? Would the registered investment advisers restructure their activities to avoid registration as a dealer, including withdrawing or reducing their trading activities or ceasing or reducing investment strategies that trigger the application of the Proposed Rules? What would be the effects of such restructuring, withdrawal, or cessation? Please explain.

7. Instead of addressing investment adviser and private fund dealer concerns under the framework of existing dealer regulation, should the Commission consider a proposed rulemaking under the Advisers Act to address these concerns? What elements should be included in such a rulemaking? For example, should it include transaction reporting and/or capital requirements?

8. Should the Commission except or exclude any other categories of persons from the scope of the Proposed Rules? If so, what persons, and why? If not, why not?

#### B. Qualitative Standards

The qualitative standards in the Proposed Rules would build on existing statements by the Commission and the courts regarding "dealer" activity to further define certain standards for determining when a person that is engaged in buying and selling securities for its own account is engaged in that activity "as a part of a regular business," as that phrase is used in Sections 3(a)(5) and 3(a)(44)(B) of the Exchange Act. Specifically, under paragraph (a)(1) of the Proposed Rules, 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 (or

government securities) that has the effect of providing liquidity to other market participants.

The Proposed Rules further identify three types of activities that would be considered to have the effect of providing liquidity to other market participants: (i) Routinely making roughly comparable purchases and sales of the same or substantially similar securities (or government securities) in a day; or (ii) routinely expressing trading interests that are at or near the best available prices on both sides of the market and that are communicated and represented in a way that makes them accessible to other market participants; or (iii) earning revenue primarily from capturing bid-ask spreads, by buying at the bid and selling at the offer, or from capturing any incentives offered by trading venues to liquidity-supplying trading interests. The following discussion of the proposed qualitative standards is applicable to both rules, and references to “dealer” activity apply equally to both “dealers” and “government securities dealers” under Sections 3(a)(5) and 3(a)(44) of the Exchange Act, respectively, unless otherwise indicated.

Under the Proposed Rules, a person’s securities trading activity would form a “part of a regular business” when that person “engages in a routine pattern of buying and selling securities [or government securities] that has the effect of providing liquidity to other market participants.”<sup>119</sup> Under this qualitative standard, when the frequency and nature of a person’s securities trading is such that the person assumes a role—described as either market-making, *de facto* market-making, or liquidity-providing—similar to the role that historically has been performed by a set of registered dealers, that person would be deemed to be acting as a dealer or government securities dealer.<sup>120</sup> As elaborated below, the Proposed Rules identify three patterns of buying and selling that the Commission views as having the effect of providing liquidity—any one of which is sufficient to require a person to register as a dealer. As discussed below, no presumption shall arise that a person is not a dealer solely because that person does not engage in the activities described in the Proposed Rules.<sup>121</sup> Other patterns of buying and selling may have the effect of providing liquidity to other market participants or

otherwise require a person to register under the Proposed Rules in accordance with applicable precedent.

The Commission has long identified activities related to liquidity provision as factors that would indicate a person is “‘engaged in the business’ of buying and selling securities.”<sup>122</sup> Historically, persons who provide liquidity in securities markets in exchange for compensation, earning revenue from the act of buying and selling itself, have registered as dealers.<sup>123</sup> And, from the enactment of the Exchange Act, the term “dealer” has included a class of liquidity providers that includes but is broader than market makers, encompassing, for example, professional floor traders who trade “in and out,” effect “‘about half of the transactions on the floor of the stock exchange,” and whose “profits depend upon . . . running along and playing with the trends and not getting caught taking positions.”<sup>124</sup> As securities markets have evolved, and new market participants have increasingly taken on market-making and liquidity-providing

<sup>122</sup> 2002 Release at 67498–500. In addition, the staff has stated that, while “the practical distinction between a ‘trader’ and a ‘dealer’ is often difficult to make and depends substantially upon the facts, . . . [a]s a general matter, a trader does not[, among other things,] . . . furnish the services which are usually provided by dealers, such as quoting the market in one or more securities.” National Council of Savings Inst., SEC No-Action Letter, 1986 WL 67129 (July 27, 1986) (the staff declined to take a no-action position with respect to national trade association’s members as “a determination of a Member’s status under the [Exchange] Act would depend upon an analysis of all of that Member’s securities activities, and not just” the activities described in the request).

<sup>123</sup> See, e.g., Exchange Act Section 3(a)(38), 15 U.S.C. 78c(a)(38) (“The term ‘market maker’ means any specialist permitted to act as a dealer, any dealer acting in the capacity of block positioner, and any dealer who, with respect to a security, holds himself out (by entering quotations in an inter-dealer communications system or otherwise) as being willing to buy and sell such security for his own account on a regular or continuous basis.”) (emphasis added). See also Stock Exchange Regulation: Hearing on H.R. 7852 and H.R. 8720 Before the Committee on Interstate and Foreign Commerce, 73rd Congr. 117 (1934) (statement of Thomas Corcoran) (“The term ‘dealer’ is broad enough to include . . . the floor trader . . . [whose] profits depend upon his running along and playing with the trends and not getting caught taking positions.”); 2002 Release at 67499 (“A person generally may satisfy the definition, and therefore, be acting as a dealer in the securities markets by . . . acting as a market maker or specialist on an organized exchange or trading system [or] acting as a *de facto* market maker whereby market professionals or the public look to the firm for liquidity . . .”).

<sup>124</sup> See Stock Exchange Regulation: Hearing on H.R. 7852 and H.R. 8720 Before the Committee on Interstate and Foreign Commerce, 73rd Congr. 117 (1934) (statement of Thomas Corcoran). See also U.S. Securities and Exchange Commission, Report on the Feasibility and Advisability of the Complete Segregation of the Functions of Dealer and Broker 21, 25, 85, 109 (1936).

roles, the Commission has stated that dealer activity includes not only “acting as a market maker” but also “acting as a *de facto* market maker whereby market professionals or the public look to the firm for liquidity.”<sup>125</sup> Traders, by contrast, the Commission indicated, do “not mak[e] a market in securities.”<sup>126</sup>

In the context of the Proposed Rules, and as discussed further below, a “pattern” of trading means buying and selling repetitively. For a pattern to come within the Proposed Rules, both purchases and sales would have to be “routine” and have “the effect of providing liquidity” to other market participants. Further, as discussed below, the Proposed Rules would set forth three standards that the Commission believes would appropriately distinguish and identify such liquidity provision as a “regular business” as opposed to non-dealer, or trader, activity.

In this respect, the Proposed Rules focus on activity rather than label or status. The Proposed Rules by their terms would cover any person (as defined above) who “engages in a routine pattern of buying and selling securities [or government securities] that has the effect of providing liquidity to other market participants,” regardless of whether the person labels itself, or is commonly known as, a PTF.

The liquidity-providing activity captured by the Proposed Rules would include not only passive liquidity-providing activity<sup>127</sup> but also aggressive trading strategies, including structural or directional trading<sup>128</sup> that similarly

<sup>125</sup> See 2002 Release at 67499.

<sup>126</sup> *Id.*

<sup>127</sup> See Algorithmic Trading Staff Report at 39 (“Passive market-making involves submitting non-marketable orders on both sides (buy or ‘bid,’ and sell or ‘offer’) of the marketplace.”).

<sup>128</sup> See *id.* at 39–41 (citing 2010 Equity Market Structure Concept Release and SEC Staff of the Division of Trading and Markets, Equities Market Structure Literature Review Part II: High Frequency Trading (Mar. 18, 2014)) (describing broad types of short-term high frequency trading strategies). 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.” See Algorithmic Trading Staff Report at 39–40; see also “Making,” “taking” and the material political economy of algorithmic trading, Donald MacKenzie, *Economy and Society*, 47:4, 501–23 (2018); High-Frequency Trading Strategies Michael Goldstein, Babson College, Amy Kwan, University of Sydney, Richard Philip, University of Sydney (Dec. 8, 2016); Exploring Market Making Strategy for High Frequency Trading: An Agent-Based Approach, Yibing Xiong, Takashi Yamada, Takao Terano (2015); SEC Staff of the Division of Trading and Markets, Equities Market Structure Literature

<sup>119</sup> See proposed Rule 3a5–4(a)(1) and proposed Rule 3a44–2(a)(1).

<sup>120</sup> See, e.g., 2002 Release at 67499.

<sup>121</sup> See proposed Rule 3a5–4(c) and proposed Rule 3a44–2(c), discussed in Section III.E.

permit a person to earn revenue from the act of buying and selling itself. In this regard, the Proposed Rules would cover persons who trade, as part of a regular business,<sup>129</sup> “in and out” and whose “profits depend upon . . . running along and playing with the trends and not getting caught taking positions”—activity understood from the enactment of the Exchange Act to be a form of dealer activity—as well as more traditional forms of liquidity provision, such as market making.<sup>130</sup>

The Proposed Rules further define three patterns of buying and selling that the Commission views as having the effect of providing liquidity, which are discussed in turn below.

#### i. Routinely Making Roughly Comparable Purchases and Sales of the Same or Substantially Similar Securities in a Day

Under the first enumerated pattern, in proposed Rules 3a44–2(a)(1)(i) and 3a5–4(a)(1)(i) respectively, a person that, trading for its own account, “routinely mak[es] roughly comparable purchases and sales of the same or substantially similar securities in a day” would be engaged in a pattern of trading that “has the effect of providing liquidity to other market participants,” and therefore be a dealer or government securities dealer.<sup>131</sup>

Review Part II: High Frequency Trading (Mar. 18, 2014). 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.

<sup>129</sup> See *supra* note 39.

<sup>130</sup> Stock Exchange Regulation: Hearing on H.R. 7852 and H.R. 8720 Before the Committee on Interstate and Foreign Commerce, 73rd Cong. 117 (1934) (statement of Thomas Corcoran). For a discussion of “liquidity providing” versus “liquidity demanding” trading strategies, see *supra* note 128.

<sup>131</sup> See, e.g., Amendments to Regulation SHO, Exchange Act Release No. 58775, 73 FR 61690, 61699 (Oct. 17, 2008) (“Regulation SHO Amendments”), in which the Commission stated that “[a] pattern of trading that includes both purchases and sales in roughly comparable amounts to provide liquidity to customers or other broker-dealers” would be one indicia of bona-fide market-making activity for purposes of the exceptions in 17 CFR 242.200 through 242.204 (Regulation SHO) to the locate and close-out requirements. The determination of eligibility for the bona-fide market-making exceptions is distinct from the determination of whether a person’s trading activity indicates that such person is acting as a dealer under the Proposed Rule. Under the Regulation SHO exception, for instance, the broker-dealer must also be providing widely disseminated quotations near or at the market and put itself at market risk. As the Commission has stated on numerous occasions, the determination of whether a particular short sale qualifies for the bona-fide market-making exception depends on the particular facts and circumstances surrounding the transaction(s). See

“Routinely” as used in this standard relates to the frequency with which a person engages in making roughly comparable purchases and sales of the same or substantially similar securities in a day. Here, “routinely” means more frequent than occasional but not necessarily continuous,<sup>132</sup> such that a person’s transactions in roughly comparable positions, throughout the day and routinely over time, constitute “[engaging] in a routine pattern of buying and selling securities that has the effect of providing liquidity for market participants” under the Proposed Rules. The Commission believes that this interpretation of “routinely” will separate persons engaging in isolated or sporadic securities transactions from persons whose regularity of participation in securities transactions demonstrates that they are acting as dealers.

As discussed above, the frequency with which a person buys and sells securities for its own account is a common component of the dealer analysis: More frequent buying and selling is indicative of dealer activity.<sup>133</sup> The first qualitative standard of the Proposed Rules describes a regularity of participation far beyond the isolated transactions of non-dealers,<sup>134</sup> and focuses on a pattern of trading because the consistency and regularity of their

*infra* note 157. 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.

<sup>132</sup> As discussed below in Section III.A.ii, the Commission believes it is appropriate to use “routine,” rather than “regular” or “continuous,” as these standards may fail to capture a number of significant firms, due to the unique characteristics of certain liquidity providers in today’s markets. Unlike many traditional types of liquidity providers, there are liquidity providers in today’s markets, such as PTFs, that despite routine participation in the market, may at times interrupt their market activity so that it is not always “continuous.” The Commission adopted a similar approach in connection with its joint rulemaking with the Commodity Futures Trading Commission regarding, among other things, the definitions of “swap dealer” and “security-based swap dealer.” See Entities Adopting Release at 30609 (“making a market in swaps is appropriately described as routinely standing ready to enter into swaps at the request or demand of a counterparty. In this regard, ‘routinely’ means that the person must do so more frequently than occasionally, but there is no requirement that the person do so continuously.”).

<sup>133</sup> See Section II.A.

<sup>134</sup> See *SEC v. Justin W. Keener d/b/a JM Financial*, No. 1:20–CV–21254 (S.D. Fla. Jan. 21, 2022) (“Case law has established that the primary indicia in determining that a person has ‘engaged in the business’ within the meaning of the term ‘dealer’ is that the level of participation in purchasing and selling securities involves *more than a few isolated transactions*.” (emphasis added) (quoting *Sodorff*, 1992 WL 224082, at \*4)).

participation indicates that their liquidity provision forms a part of a regular business.

Under the Proposed Rules, “roughly comparable” would generally capture purchases and sales similar enough, in terms of dollar volume, number of shares, or risk profile, to permit liquidity providers to maintain near market-neutral positions by netting one transaction against another transaction. To be “roughly comparable,” the dollar volume or number of shares of, or risk offset by, the purchases and sales need not be exactly the same, as requiring a full netting of positions may fail to capture a number of significant firms, due to the unique characteristics of certain liquidity providers in today’s markets.<sup>135</sup> Instead, “roughly comparable” purchases and sales would fall within a reasonable range that generally would have the effect of offsetting one transaction against the other. Generally speaking, although the Proposed Rules do not provide a bright-line test in connection with the qualitative factors, the Commission believes that a person that closes or offsets, in the same day, the overwhelming majority of the positions it has opened, has likely made “roughly comparable purchases and sales.”<sup>136</sup> This proposed standard would capture a fundamental aspect of both the traditional dealer—who “buys securities . . . with a view to disposing them elsewhere” and “receives no brokerage commission but relies for his compensation upon a favorable difference or spread between the price at which he buys and the amount for which he sells”<sup>137</sup>—and the liquidity provider whose trading strategies generally involve frequent turnover of positions on a short-term basis, with overnight holdings of unhedged positions that are a fraction of their overall intraday positions.<sup>138</sup>

<sup>135</sup> See, e.g., 2002 Release (focusing, among other things, on a “regular turnover of inventory” rather than requiring completely neutral positions).

<sup>136</sup> The Proposed Rules do not provide a bright-line test to determine “roughly comparable” purchases and sales. However, for purposes of the Economic Analysis of the Proposed Rules, the Commission assumes a daily buy-sell imbalance between two identical or substantially similar securities, in terms of dollar volume, below 10 percent or, alternatively, 20 percent may be indicative of purchases and sales that are “roughly comparable,” as described below in Section V.B.2.c. The Commission has requested comment on whether this approach is appropriate and whether this standard should include a trading threshold.

<sup>137</sup> See U.S. Securities and Exchange Commission, Report on the Feasibility and Advisability of the Complete Segregation of the Functions of Dealer and Broker XIV (1936).

<sup>138</sup> See 2010 Equity Market Structure Concept Release at 3607–09. See also 2015 Joint Staff Report.

The Proposed Rules reflect the statutory distinction between “dealers” and “traders.” The Commission has long distinguished dealer activity from trader activity by focusing on, among other things, a dealer’s frequent turnover of positions—stating, for example, that the dealer “sells securities . . . he has purchased or intends to purchase elsewhere or buys securities . . . with a view to disposing of them elsewhere”<sup>139</sup>—as well as the frequency with which a person buys and sells.<sup>140</sup> By targeting persons who routinely make roughly comparable purchases and sales of the same or substantially similar securities, the Proposed Rules identify persons whose trading has the effect of providing liquidity that requires dealer registration, and so distinguish those persons who are acting as traders.<sup>141</sup>

The Proposed Rules take into account the speed at which technology permits liquidity providers today to turn over their positions and the fact that high-speed, anonymous trading platforms allow liquidity providers to act as intermediaries without customers and without holding an inventory of securities.<sup>142</sup> In addition, the Proposed Rules take into consideration the frequency with which a person buys and sells securities, which is a factor historically considered as part of the dealer analysis.<sup>143</sup> Because they are based on activity, the Proposed Rules would cover not only PTFs, but also any other persons engaging in the identified activities.

Paragraph (a)(1)(i) of the Proposed Rules would also provide that the securities bought and sold must be “the same or substantially similar” in order to further distinguish liquidity providing dealer activity from non-dealer trader activity. As discussed above, routinely making roughly comparable purchases and sales of securities keeps a liquidity provider’s market positions near neutral only to

the extent that a sale or another trade offsets the risk taken on through a purchase. For purposes of the rule, “the same” securities means that the securities bought and sold are securities of the same class and having the same terms, conditions, and rights.<sup>144</sup> Securities bearing the same Committee on Uniform Securities Identification Procedures (“CUSIP”) number, for example, would be considered “the same.” In addition, the determination of what would constitute “substantially similar” securities for purposes of the rule would be based on the facts and circumstances analysis that would take into account factors such as, for example, whether: (1) The fair market value of each security primarily reflects the performance of a single firm or enterprise or the same economic factor or factors, such as interest rates; and (2) changes in the fair market value of one security are reasonably expected to approximate, directly or inversely, changes in, or a fraction or a multiple of, the fair market value of the second security. A person routinely making roughly comparable purchases and sales of the same or substantially similar securities, such that the sale or purchase of one security offsets the risk associated with the sale or purchase of the other, permitting that person to maintain a near market-neutral position, would meet this aspect of this standard.

Applying these principles, the Commission believes that the following are nonexclusive examples of purchases and sales of “substantially similar” securities:

- Selling a Treasury security and buying another Treasury security in the same maturity range, as used by the Federal Reserve Bank of New York’s Open Market Operations.<sup>145</sup> For example, selling a 4.5-year Treasury security and buying a 5-year Treasury security, or a 9.5 year Treasury security versus a 10-year Treasury security.
- Buying an exchange traded fund and selling the underlying securities that make up the basket of securities held by the exchange traded fund that was purchased.
- Buying a European call option on a stock and selling a European put option

on the same stock with the same strike and maturity.

- Buying an OTC call option on a stock and selling a listed option on the same stock with the same strike and maturity.

Conversely, the Commission believes that the following are examples of purchases and sales of securities that are not “substantially similar”:

- Buying stock in one company (*e.g.*, Ford) and selling stock in another company in the same industry (*e.g.*, Chrysler).
- Buying stock and selling bonds issued by the same company.
- Buying cash Treasury securities and selling Treasury futures.

Finally, the standard under paragraph (a)(1)(i) of the Proposed Rules would apply with respect to purchases and sales made “in a day.” As discussed above, dealer liquidity providers are distinguishable, in part, from traders and other market participants by the frequent turnover of their positions. Traditional dealers often hold an inventory to enable them to buy from one market participant and sell to another. Technological advancements have increased the speed at which this process happens, eliminating in some cases the need to carry a traditional inventory at all, as liquidity providers are able to source and unload securities extremely rapidly. The Commission believes that a temporal component is necessary in paragraph (a)(1)(i) to distinguish dealer liquidity providers from other market participants who may contribute liquidity to the market periodically but not in the repeated, routine—and often relied upon—manner of liquidity providers. The Commission believes that “in a day” is a period of sufficient duration to capture the trading activity typical of dealer liquidity providers that are the focus of the Proposed Rules, and still brief enough to exclude non-dealers pursuing longer-term investment strategies. In addition, because PTFs tend to turn over their positions over the course of a day, “end[ing] the day with little net directional exposure,”<sup>146</sup> market practices support drawing the temporal line at the end of the day.

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

Proposed Rules 3a44–2(a)(1)(ii) and 3a5–4(a)(1)(ii) set forth the second

<sup>139</sup> See U.S. Securities and Exchange Commission, Report on the Feasibility and Advisability of the Complete Segregation of the Functions of Dealer and Broker XIV (1936).

<sup>140</sup> See Section II.A.

<sup>141</sup> See Section I.

<sup>142</sup> See, *e.g.*, Stock Exchange Regulation: Hearing on H.R. 7852 and H.R. 8720 Before the Committee on Interstate and Foreign Commerce, 73rd Cong. 117 (1934) (statement of Thomas Corcoran) (discussing floor traders, which have long been viewed as dealers). As the markets have evolved, the role of floor traders has largely been replaced by PTFs, which play a role—albeit, electronically and through the use of algorithmic trading strategies—similar to that of the floor traders that traditionally have been regulated as dealers. See 2010 Equity Market Structure Concept Release at 3607–08.

<sup>143</sup> See Section II.A.

<sup>144</sup> See 17 CFR 227.300(b)(2) (Rule 300(b)(2) of Regulation Crowdfunding) (permitting an intermediary to have a financial interest in an issuer if, among other things, the financial interest consists of securities of the same class and having the same terms, conditions and rights as the securities being offered and sold on the intermediary’s platform).

<sup>145</sup> See Federal Reserve Bank of New York, “FAQs: Treasury Purchases,” <https://www.newyorkfed.org/markets/treasury-reinvestments-purchases-faq>.

<sup>146</sup> See 2021 IAWG Joint Staff Report at 5.

pattern of trading activity that “has the effect of providing liquidity to other market participants.” Specifically, under paragraph (a)(1)(ii), a person buying and selling for its own account that “routinely express[es] 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” would be engaged in a pattern of trading in securities or government securities that “has the effect of providing liquidity to other market participants,” and therefore would be a dealer or government securities dealer under the Proposed Rules. As discussed below, the Proposed Rules would update the longstanding understanding that regular or continuous quotation is a hallmark of market making (and, hence, dealer) activity,<sup>147</sup> to reflect technological changes to the ways in which buyers and sellers of securities are brought together.

The Proposed Rules would apply when a person “routinely” expresses trading interests. Here, as well as in paragraph (a)(1)(i), “routinely” means that the person must express trading interests more frequently than occasionally, but not necessarily continuously.<sup>148</sup> As discussed above in connection with paragraph (a)(1)(i), “routinely” relates to the frequency of the activity both intraday and across time, and means both repeatedly within a day and on a regular basis over time. The Commission believes it is appropriate to use “routinely,” rather than “regular” or “continuous,” as the latter standards may fail to capture a number of significant firms, due to the unique characteristics of certain liquidity providers in today’s markets. Specifically, by using “routinely,” the Proposed Rules are intended to reflect market evolution to capture significant liquidity providers who express trading interests at a high enough frequency to

play a significant role in price discovery and the provision of market liquidity, even if their liquidity provision may not be continuous like that of some traditional dealers. At the same time, they are very active in the markets—their participation is very routine—as demonstrated by the “key role” they play “in price discovery and the provision of market liquidity” in both the interdealer U.S. Treasury market<sup>149</sup> and the equity markets.<sup>150</sup>

Paragraph (a)(1)(ii) would also use the term “trading interest” rather than “quotations.” The Commission has recently proposed to define “trading interest” to mean “an order, as defined in paragraph (e) of [Rule 300 of Regulation ATS],<sup>151</sup> or any non-firm indication of a willingness to buy or sell a security that identifies at least the security and either quantity, direction (buy or sell), or price.”<sup>152</sup> Technological advancements have proliferated methods by which market participants hold themselves out as willing to buy or sell securities, or otherwise communicate their willingness to trade. The broader term “trading interest” would reflect the prevalence of non-firm trading interest offered by market places today,<sup>153</sup> and account for the varied ways in which developing technologies permit market participants to effectively make markets. The broader term appropriately captures the traditional quoting engaged in by dealer liquidity providers, new and developing quoting equivalents, and the orders that actually result in the provision of liquidity that the Commission intends the Proposed Rules to address. Using “trading interest,” as defined above, rather than “quotation” will allow for clear and consistent application of the definition of dealer and government securities dealer.

<sup>149</sup> 2021 IAWG Joint Staff Report at 5, 13.

<sup>150</sup> See, e.g., Algorithmic Trading Staff Report; 2010 Equity Market Structure Concept Release.

<sup>151</sup> 17 CFR 242.300(e) defines an “order” to mean “any firm indication of a willingness to buy or sell a security, as either principal or agent, including any bid or offer quotation, market order, limit order, or other priced order.”

<sup>152</sup> See 2022 ATS Proposing Release, proposed Rule 300(q). In proposing this new term, the Commission noted the incidence of “non-firm trading interest that includes the symbol and one of the following: quantity, direction, or price. . . . The Commission believes that . . . the use of a message that identifies the security and either the quantity, direction, or price would provide sufficient information to bring together buyers and sellers of securities because it allows a market participant to communicate its intent to trade and a reasonable person receiving the information to decide whether to trade or engage in further communications with the sender.” *Id.* at 15505.

<sup>153</sup> See 2022 ATS Proposing Release at 15500–15502.

Further, the Commission is proposing that the rules encompass trading interests expressed “at or near the best available prices on both sides of the market.”<sup>154</sup> The phrase “best available prices on both sides of the market” more specifically and clearly describes the activity of liquidity-providing dealers, which help determine the spread between the best available bid price and the best available ask price for a given security. Among other market benefits, by competing to both buy and sell at the best available prices, liquidity providers help to narrow bid-ask spreads.<sup>155</sup> The Commission further believes that the proposed formulation helps emphasize that a liquidity provider, to come within the rule, must both buy and sell securities.<sup>156</sup>

Finally, the Proposed Rules would apply only when these trading interests that are at or near the best available prices on both sides of the market are “communicated and represented in a way that makes them accessible to other market participants.” Under the Proposed Rules, a market participant that routinely makes these trading interests available to other market participants would be considered to have engaged in a routine pattern of trading that has the effect of providing liquidity to other market participants.<sup>157</sup>

<sup>154</sup> See, e.g., Regulation SHO Amendments, in which the Commission stated that quotations near or at the market for a short sale in a security may provide an indication of bona-fide market making for purposes of Regulation SHO, depending on the facts and circumstances surrounding the activity. See also *supra* note 131.

<sup>155</sup> See, e.g., Prohibitions and Restrictions on Proprietary Trading, Release No. BHCA-1; File No. S7-41-11 (Dec. 10, 2013), 79 FR 5535, 5585–86 (Jan. 31, 2014), available at <https://www.sec.gov/rules/final/2013/bhca-1.pdf> (setting forth, among other things, the circumstances in which a banking entity may engage market making-related activities) (“Volcker Rule Adopting Release”) at 177.

<sup>156</sup> See, e.g., 15 U.S.C. 78c(a)(5) (“The term ‘dealer’ means any person engaged in the business of buying and selling securities” (emphasis added)); see also 15 U.S.C. 78c(a)(44).

<sup>157</sup> See, e.g., Regulation SHO Amendments (“Continuous quotations that are at or near the market on both sides and that are 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.”). But see *supra* note 131 (explaining that the determination of eligibility for Regulation SHO’s bona-fide market-making exceptions is distinct from the determination of whether a person’s trading activity indicates that such person is acting as a dealer under the Proposed Rule). The Commission further notes that the bona-fide market-making exceptions under Regulation SHO are only available to registered broker-dealers that publish continuous quotations for a specific security in a manner that puts the broker-dealer at economic risk. Broker-dealers that do not publish continuous quotations, or publish quotations that do not subject the broker-dealer to such risk (e.g., quotations that are not publicly accessible, are not near or at the market,

<sup>147</sup> The term “market maker” includes, among other things, “any dealer who, with respect to a security, holds itself out (by entering quotations in an inter-dealer quotation system or otherwise) as being willing to buy and sell such security for its own account on a regular or continuous basis.” See 15 U.S.C. 78c(a)(38). Moreover, the Commission has stated previously that a market maker engaged in bona-fide market making is a “broker-dealer that deals on a regular basis with other broker-dealers, actively buying and selling the subject security as well as regularly and continuously placing quotations in a quotation medium on both the bid and ask side of the market.” See, e.g., Exchange Act Release No. 32632 (July 14, 1993), 58 FR 39072, 39074 (July 21, 1993).

<sup>148</sup> See, e.g., Entities Adopting Release at 30609 (“In this regard, ‘routinely’ means that the person must do so more frequently than occasionally, but there is no requirement that the person do so continuously.”).

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

Proposed Rules 3a44–2(a)(1)(iii) and 3a5–4(a)(1)(iii) set forth the final enumerated pattern of activity that “has the effect of providing liquidity to other market participants.” Under paragraph (a)(1)(iii) of each rule, a person that, trading for its own account, “earn[s] 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,” would be engaging in a routine pattern of trading that has the effect of providing liquidity to other market participants, and as a result, would be a dealer under the Proposed Rules.

As with other aspects of the Proposed Rules, this standard focuses on activity rather than label or status. The Proposed Rules would apply to any person regardless of whether the person labels itself, or is commonly known as, a PTF.

As discussed above, one fundamental characteristic typical of market makers and liquidity providers—and one that has historically been viewed as dealer activity—is trading in a manner designed to profit from spreads or liquidity incentives, rather than with a view toward appreciation in value.<sup>158</sup> The Commission has previously identified a person’s seeking, through its presence in the market, compensation through spreads or fees, or other compensation not attributable to changes in the value of the security traded, as a factor indicating dealer activity.<sup>159</sup> Dealer liquidity providers

or are skewed directionally towards one side of the market), would not be eligible for the bona-fide market-maker exceptions under Regulation SHO. In addition, broker-dealers that publish quotations but fill orders at different prices than those quoted would not be engaged in bona-fide market making for purposes of Regulation SHO.

<sup>158</sup> See, e.g., U.S. Securities and Exchange Commission, Report on the Feasibility and Advisability of the Complete Segregation of the Functions of Dealer and Broker XIV (1936) (“The dealer . . . receives no brokerage commission but relies for his compensation upon a favorable difference or spread between the price at which he buys and the amount for which he sells.”). See also Entities Adopting Release at 30609 (“seeking to profit by providing liquidity to the market is an indication of dealer [as opposed to trader] activity”).

<sup>159</sup> See Entities Adopting Release at 30617 (identifying as an indication of dealer activity which is consistent with the definition’s “regular business” requirement, “seeking compensation in connection with providing liquidity . . . by seeking a spread, fees or other compensation not attributable to changes in the value of the [security itself]”). With respect to bid-ask spreads, the

frequently are distinguishable from other market participants whose trades arguably “provide liquidity” inasmuch as dealers seek to be compensated for the service of contributing to a market’s liquidity, whether by bid-ask spreads or liquidity incentives. They are “in the business” of providing liquidity because they routinely supply it and the revenue they earn as a result through bid-ask spreads or liquidity incentives is their primary source of revenue.

Both forms of revenue are accounted for in the Proposed Rules. The first—capturing bid-ask spreads—is done by buying at the bid and selling at the offer, which would include buying at a lower price than, and selling at a higher price than, the midpoint of the bid-ask spread. The spread between these prices compensates them for providing the service of liquidity—that is, of generally standing ready to buy or sell and enabling other market participants to reliably make purchases and sales. When a liquidity provider routinely buys and sells securities in a manner designed to capture a spread with such frequency and consistency that its revenue is made up primarily of this form of compensation, it will be considered to be engaged in a routine pattern of providing liquidity as a service and will fall within the scope of the rules.

The second major source of revenue for market makers and other liquidity providers is explicit liquidity-compensation arrangements. For example, many exchanges in the equities markets have adopted a “maker-taker” pricing model to compensate (and thereby attract) liquidity providers.<sup>160</sup> Under this model, non-marketable, resting orders that offer (make) liquidity at a particular price receive a liquidity rebate if they are executed, while incoming orders that execute against (take) the liquidity

connection between liquidity provision and bid-ask spreads is evident in the relationship among high volume, liquidity, and bid-ask spreads: Because high volume can reduce a dealer’s overhead, high volume tends to make liquidity provision more profitable; as liquidity provision becomes more profitable, more persons compete to provide liquidity, and this increased competition tightens bid-ask spreads, as the more competitive liquidity providers are willing to be compensated less for the liquidity they provide in order to compete. See Section V.C.3.c. See also Volcker Rule Adopting Release at 177 (“[L]iquidity provides important benefits to the financial system, as more liquid markets are characterized by competitive market makers, narrow bid-ask spreads, and frequent trading.”). Notably, a person may be acting as a dealer by profiting from a spread even if they are not profiting from “bid-ask spreads” under the Proposed Rules. See, e.g., *River North*, 415 F. Supp. at 859 (discussing *Sodorff*, 1992 WL 224082, at \*5).

<sup>160</sup> See 2010 Equity Market Structure Concept Release at 3599.

of resting orders are charged an access fee.<sup>161</sup> When a liquidity provider, as a result of its routine purchases and sales of securities, captures “incentives offered by trading venues to liquidity-supplying trading interests” with such frequency and consistency that its revenue is made up primarily of this form of compensation, it will be considered to be engaged in a routine pattern of providing liquidity as a service and generally standing ready to buy or sell securities, so would fall within the scope of the Proposed Rules.

To come within this paragraph of the Proposed Rules, a liquidity provider would have to earn its revenue primarily from bid-ask spreads or trading incentives. The Proposed Rules use the phrase “earn revenue”—rather than, for example, “profit from”—to make clear that a person’s trading strategies would not need to be profitable to bring them within the rule because a market participant can provide liquidity without being profitable. Furthermore, under the Proposed Rules, a person whose revenue is derived “primarily” from capturing bid-ask spreads or liquidity incentives, or a combination of the two, would be a liquidity provider that is engaged in the regular business of buying and selling securities for its own account and, as a result, a dealer or government securities dealer. Generally speaking, although the Proposed Rules do not provide a bright-line test in connection with the qualitative factors, the Commission believes that if a person derives the majority of its revenue from the sources described in paragraph (a)(3)(iii), it would likely be in a regular business of buying and selling securities or government securities for its own account.

Finally, the paragraph would apply with respect to activity on “trading venues.” The Commission has recently proposed to define the term “trading venue” to mean “a national securities exchange or national securities association that operates an SRO trading facility, an ATS, an exchange market maker, an OTC market maker, a futures or options market, or any other broker- or dealer-operated platform for executing trading interest internally by trading as principal or crossing orders as agent.”<sup>162</sup>

Market evolution has given rise to a variety of venues in which liquidity providers can express trading interests,

<sup>161</sup> See 2010 Equity Market Structure Concept Release at 3599. Highly automated exchange systems and liquidity rebates have contributed to the rise of PTFs that focus on liquidity provision. *Id.*

<sup>162</sup> 2022 ATS Proposing Release at 15540.

and the definition is designed to capture the breadth of these different venues. For example, Communication Protocol Systems, which are electronic systems that offer the use of non-firm trading interest and make available communication protocols to bring together buyers and sellers of securities but do not fall within the current definition of an “exchange” under Federal securities laws, have come to perform the function of a market place and become a preferred method for market participants to discover prices, find counterparties, and execute trades.<sup>163</sup> The Proposed Rules are designed to capture dealer activity wherever that activity occurs, whether on a national securities exchange, an ATS, a Communication Protocol System, or another form of trading venue. For purposes of the Proposed Rules, the particular trading venue matters less than the fact that a market participant provides liquidity on it. Using the broad term “trading venue,” as defined above, will allow for clear and consistent application of the definitions of dealer and government securities dealer.

#### Request for Comment

The Commission generally requests comment on these provisions of the Proposed Rules. In addition, the Commission requests comments on the following specific issues:

9. Is there sufficient specificity provided for the terms used in the qualitative standards? Are there any terms that should be defined in rule text or addressed in the release?

- Is there sufficient specificity provided for the term “pattern”? If not, what additional specificity should the Commission provide and please provide specific examples on the types of specificity. Should the rule text define what is meant by “pattern”? Why or why not? Is the Proposed Rules’ use of “pattern” appropriate? Would “manner” or another word be more appropriate? Why or why not?

- Is there sufficient specificity provided for the term “effect of providing liquidity”? If not, what additional specificity should the Commission provide and please provide specific examples on the types of specificity. Should the rule text define what is meant by “effect of providing liquidity”? Why or why not? Is the Proposed Rules’ use of “effect of providing liquidity” appropriate? Would replacing “effect of providing

liquidity” with “market making” be more appropriate? Are there other words that would be more appropriate? Why or why not?

- Is there sufficient specificity provided for the term “primarily”? Should the rule text define what is meant by “primarily”? Why or why not? Is the Proposed Rules’ use of “primarily” appropriate? Would “mostly” or another word be more appropriate? Why or why not?

- Is there sufficient specificity provided for the term “trading venue”? If not, what additional specificity should the Commission provide and please provide specific examples on the types of specificity. Should the rule text define what is meant by “trading venue”? Why or why not? Is the Proposed Rules’ use of “trading venue” appropriate? Are there other words that would be more appropriate? Why or why not?

10. Is liquidity provision an appropriate factor to use in defining which buying and selling activity for one’s own account qualifies as “regular business”? Are there other factors the Commission should include? If so, which factors and why? Are there trading activities or investment strategies that should not be considered providing liquidity? If so, please describe why.

11. Are the three qualitative factors identified in the Proposed Rules as having the “effect of providing liquidity to other market participants” that would qualify as “regular business” appropriate? Are there any other forms of liquidity provision, or any other factors, that the Commission should include or exclude instead or in addition to those proposed? Are the factors over or under-inclusive? If so, please provide specific examples of any alternative suggestions.

- For example, should the Commission include as an example of a “liquid market,” “a market in which participants have the ability to readily trade at a predictable price and in a desired size without materially moving the market”? Why or why not?

- In addition to passive “liquidity providing” trading strategies, the Proposed Rules would capture certain aggressive “liquidity demanding” strategies as having the “effect of providing liquidity to other market participants”? Is this appropriate? Why or why not?

12. Under the Proposed Rules, a person routinely making roughly comparable purchases and sales of the same or substantially similar securities in a day would have the effect of providing liquidity to other market

participants, and therefore would be a dealer. Is this an appropriate measure or illustration of liquidity provision? Why or why not? Would the provision capture persons that should not be dealers? If so, who and why?

- For example, would the Proposed Rules capture private funds and other persons pursuing investment strategies such as relative value fixed income arbitrage or share class arbitrage? If so, should such strategies be included or excluded? Why or why not?

- Is there sufficient specificity to determine which securities would be considered “same” or “substantially similar”? Why or why not? If not, what additional specificity should the Commission provide and please provide specific examples on the types of specificity. Should additional or different factors be considered? Are there other words that would be more appropriate? Why or why not?

- Should the rule text define what is meant by “same” or “substantially similar”? Why or why not?

- Are there other types of purchase and sale transactions that would be examples of purchases and sales of securities that are “substantially similar” (*i.e.*, other types of roughly comparable purchases and sales of substantially similar securities, such that the sale or purchase of one security offsets the risk associated with the sale or purchase of the other, permitting a person to maintain a near market-neutral position)? Are there examples of types of purchase and sale transactions involving derivatives, or other products that represent the economic equivalent of another security, that would be purchases and sales of securities that are “substantially similar”? Please explain.

13. Although the Proposed Rules do not provide a bright-line test to determine “roughly comparable” purchases and sales, depending on the facts and circumstances, the Commission believes a daily buy-sell imbalance, as described below in Section V.B.2.c., between two identical or substantially similar securities, in terms of dollar volume below 20 percent may be indicative of purchases and sales that are “roughly comparable.” Is this an appropriate measurement of “roughly comparable”? Why or why not? Would another measurement be more appropriate? Should there be a minimum trading volume or dollar amount threshold as part of the qualitative standard under paragraph (a)(1)(i), daily buy-sell imbalance, or other measurement?

- Is there sufficient specificity provided for the term “roughly comparable”? Why or why not? If not,

<sup>163</sup> See 2022 ATS Proposing Release at 15496 n.5 and 15501. This is particularly true for government securities and other fixed income securities. *Id.*

what additional specificity should the Commission provide and please provide specific examples on the types of specificity. Is the Proposed Rules' use of "roughly comparable" appropriate? Are there other words that would be more appropriate? Why or why not?

- Should the rule text define, as opposed to the release addressing, what is meant by "roughly comparable"? Why or why not?

- Does there need to be more specificity provided as to how many transactions must be executed (or positions opened and/or closed) in a day to be "roughly comparable"?

- Is "in a day" an appropriate period of time during which to measure whether a person has made roughly comparable purchases and sales of the same or substantially similar securities? If not, what is an appropriate time period?

- If an institutional investor seeks to rebalance its portfolio, would the institutional investor typically "routinely make roughly comparable purchases and sales of the same or substantially similar securities in a day," or otherwise trigger the Proposed Rules?

14. Under the Proposed Rules, a person that "routinely express[es] 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" would have the effect of providing liquidity to other market participants, and thus would be a dealer. Is this an appropriate measure or illustration of liquidity provision? Why or why not? Would the provision capture persons that should not be dealers? If so, who and why?

- Is the Proposed Rules' use of "routinely" appropriate? Would "regularly" or "continuously" or another word be more appropriate? Why or why not?

- Is there sufficient specificity provided for the term "routinely"? If not, what additional specificity should the Commission provide and please provide specific examples on the types of specificity. Should the rule text define what is meant by "routinely"? Why or why not?

- Is the Proposed Rules' use of "trading interest" appropriate? Would "quotations" or another term be more appropriate? Why or why not?

- Is there sufficient specificity provided for the term "trading interest"? Should the rule text define what is meant by "trading interest"? Why or why not? If not, what additional specificity should the Commission

provide and please provide specific examples on the types of specificity.

- The Proposed Rules would require that trading interests be communicated and represented in a way that makes them accessible to other market participants in order to come within the rule. Should the Commission require that the trading interests be communicated "widely"? Why or why not?

15. Under the Proposed Rules, a person that "earn[s] 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 interest," would have the effect of providing liquidity to other market participants. Is this an appropriate measure or illustration of liquidity provision? Why or why not? Would the provision capture persons that should not be dealers? If so, who and why?

- Is there sufficient specificity provided for the term "earn revenue"? If not, what additional specificity should the Commission provide and please provide specific examples on the types of specificity. Is the Proposed Rules' use of "earn revenue" appropriate? Are there other words that would be more appropriate? Why or why not? Should the rule text define what is meant by "earn revenue"? Why or why not?

- Should the Proposed Rules include additional or other forms of revenue?

- Should the Proposed Rules include other measures of liquidity provision? If so, what measures and why?

- As explained above, buying at the bid and selling at the offer would include buying at lower than, and selling at higher than, the midpoint of the bid-ask spread. Should the rule text define "capturing bid-ask spread" to expressly include buying at lower than, and selling at higher than, the midpoint of the bid-ask spread?

16. Do the Proposed Rules provide sufficient specificity to permit market participants to distinguish between revenue derived from capturing bid-ask spreads and revenue derived from realization of appreciation of the underlying asset?

### C. Quantitative Standard

In addition to the qualitative standards described above, proposed Rule 3a44-2 would also include a quantitative standard that would establish a bright-line test under which persons engaging in certain specified levels of activity in the U.S. Treasury market would be defined to be buying and selling securities "as a part of a regular business," regardless of whether

they meet any of the qualitative standards. Specifically, proposed Rule 3a44-2(a)(2) would provide that a person<sup>164</sup> that is engaged buying and selling government securities for its own account is engaged in such activity "as a part of a regular business" if that person in each of four out of the last six calendar months, engaged in buying and selling more than \$25 billion of trading volume in government securities as defined in Section 3(a)(42)(A) of the Exchange Act.<sup>165</sup>

The Commission believes that four out of the last six calendar months is an appropriate range of time to evaluate the trading volume of a market participant and should help to ensure the proposed quantitative standard does not capture market participants with relatively low trading volume that may have had an anomalous increase in trading. The proposed time measurement period would smooth monthly variations by reducing the effect of trading fluctuations in a particular month that could misrepresent or distort a market participant's overall trading pattern.<sup>166</sup> A shorter period of time could potentially cause a market participant to fall within the scope of the quantitative standard solely as a result of an atypical, short-term increase in trading, which

<sup>164</sup> In light of the statutory definition of "person," in conjunction with the proposed definitions of "own account" and "control," as discussed in Section III.D, trading volume would be determined by aggregating volume at the firm or legal-entity level (rather than market participant identifier ("MPID") or global firm level). See 15 U.S.C. 78c(a)(9).

<sup>165</sup> Proposed Rule 3a44-2(a)(2) only applies to government securities as defined in Section 3(a)(42)(A) of the Exchange Act. Accordingly, the trading volume threshold set forth in the proposed rule does not apply to all government securities as defined by Section 3(a)(42); but rather, it is limited to "securities which are direct obligations of, or obligations guaranteed as to principal or interest by, the United States" ("U.S. Treasury Securities"). See 15 U.S.C. 78c(a)(42)(A). For purposes of determining whether the trading volume threshold is met, a person would include transactions in U.S. Treasury Securities—that is, Treasury bills, notes, floating rate notes, bonds, inflation-protected securities ("TIPS"), and Separate Trading of Registered Interest and Principal Securities ("STRIPS")—and would exclude auction awards and repurchase or reverse repurchase transactions in U.S. Treasury Securities. See 2022 ATS Proposing Release at 15542 nn. 512–517 (describing U.S. Treasury Securities). Additionally, for purposes of determining whether the trading volume threshold is met, Treasury when-issued transactions would be included.

<sup>166</sup> This Commission has adopted regulations that use the four out of the last six calendar months metric in Regulation ATS, Rules 301(b)(5) and (6), and Regulation SCI Rule 1000. See 17 CFR 242.301(b)(5)–(6) (definition of an SCI alternative trading system or SCI ATS); see also Regulation Systems Compliance and Integrity, Exchange Act No. 73639 (Nov. 19, 2014), 79 FR 72251 (Dec. 5, 2014) (noting that time measurement period of four of the preceding six months is consistent with the current standard under Regulation ATS).

potentially could discourage participation in the U.S. Treasury market by a new market participant that has not had as long of a time period to develop its business prior to having to incur compliance costs associated with being subject to dealer registration. In addition, the Commission does not believe that a longer period of time is necessary to identify those market participants that play a significant role, and regularly transact, in U.S. Treasury Securities. The Commission believes that the proposed time measurement period provides sufficient trading history data so as to indicate a market participant's significance to the market, and that the structure of the measurement (*i.e.*, requiring a market participant to meet the threshold for four out of the last six calendar months) identifies regularity of such significant trading levels.

As discussed below, the Commission's analysis of market participants that are not members of FINRA in the U.S. Treasury market found that these participants accounted for approximately 19 percent of the aggregate Treasury trading volume in July 2021, with PTFs representing the highest volumes of trading among these participants.<sup>167</sup> In addition, PTFs dominate the interdealer U.S. Treasury market, representing 61 percent of the trading activity on the electronic IDB platforms and 48 percent of the total interdealer market.<sup>168</sup>

Although, as noted previously, the Proposed Rules alone will not necessarily prevent future market disruptions, the operation of proposed Rule 3a44-2 will support transparency; market integrity and resiliency; and investor protection across the U.S. Treasury market by helping to close the regulatory gap that currently exists and by ensuring consistent regulatory oversight.<sup>169</sup> The lack of consistent

visibility across the market today constrains the ability of regulators to understand and respond to significant market events. The proposed quantitative standard is intended to capture the most significant market participants that are regularly buying and selling U.S. Treasury Securities, and subject these participants that are not already registered as dealers or government securities dealers to a regulatory regime designed to minimize the risks they may pose to the U.S. Treasury market and provide regulators with appropriate oversight of their activities.

As described below in Section V, the proposed trading volume threshold was derived from analysis of historical U.S. Treasury Securities transactions reported to TRACE.<sup>170</sup> Based on this analysis, the Commission is proposing a trading volume amount of \$25 billion; this quantitative standard would likely capture mostly unregistered PTFs, but also may capture certain other significant market participants not currently registered as government securities dealers.<sup>171</sup> In determining whether the trading volume threshold is met, a market participant would include transactions in U.S. Treasury Securities that are currently reported to TRACE—that is, Treasury bills, notes, floating rate notes, bonds, TIPS, and STRIPS—and would exclude auction awards and repurchase or reverse repurchase transactions in U.S. Treasury

examinations. *See* Section V.B.3. Market participants that are private funds are generally managed by registered investment advisers that file regular financial reports with the Commission on Form PF, and are subject to examination concerning their private fund clients, but private funds do not report securities transactions such as those required by the rules governing registered dealers. *See id.* Transactions in fixed income securities, such as U.S. Treasury Securities, are not currently reported to the Consolidated Audit Trail (“CAT”). *See* Section V.B.2 (explaining the type of transactions reported to CAT).

<sup>170</sup> TRACE reporting requirements apply to all marketable U.S. Treasury Securities, including Treasury bills, notes, floating rate notes, bonds, TIPS, and STRIPS. *See* FINRA Rule 6700 series. Under FINRA Rules, “Bona fide repurchase and reverse repurchase transactions involving TRACE-Eligible Securities” and “Auction Transactions” are not reported to TRACE. *See* FINRA Rule 6730(e).

<sup>171</sup> As described in Section V.B.2, the analysis found 46 non-FINRA member firms with trading volumes of at least \$25 billion in July 2021. Based on classifications (further explained *infra* note 218), of these 46 non-FINRA member firms, 22 are classified as PTFs and 20 are classified as dealers. *See* Section V.B.2, Table 1. To the extent a non-FINRA member firm is a financial institution, it would not register with the Commission but instead would provide written notice of its government securities dealer status with the appropriate Federal banking regulator. *See* Section II; 17 CFR 400.1. Additionally, a non-FINRA member firm may be operating in reliance on an exception or exemption. *See supra* note 29 and accompanying text.

Securities.<sup>172</sup> The proposed quantitative standard is intended to be a straightforward threshold identifying those market participants that, as a result of their regularly high trading volume in government securities, serve dealer-like roles significantly impacting the U.S. Treasury market. In this regard, the Commission believes that setting forth a trading volume threshold would provide an easily measurable and observable standard.

As discussed above, the market structure for U.S. Treasury securities has evolved, with PTFs accounting for a large percent of trading volume.<sup>173</sup> In some ways, PTFs have displaced the role of traditional dealers in the interdealer U.S. Treasury market, and the Commission believes that PTFs, and other market participants that similarly have a significantly large, and regular, amount of trading volume and have a significant impact on the U.S. Treasury market, should register as government securities dealers.<sup>174</sup> Proposed Rule 3a44-2(a)(2) is designed to make clear the Commission's view that a person engaging in this regular volume of buying and selling activity is engaged in the buying and selling of government securities for its own account as a part of a regular business, and therefore, should be subject to the same regulatory requirements as other dealers.

The Commission believes the need for a quantitative rule is most acute in the U.S. Treasury market. Thus, while proposed Rules 3a5-4 and 3a44-2 share common qualitative standards, the Commission is proposing a quantitative standard only with respect to the U.S. Treasury market at this time. As explained more fully in Section V, the quantitative standard is derived from trading data related to the U.S. Treasury market, and is intended to identify significant market participants not registered as dealers that are performing dealer-like activities in the U.S. Treasury market.<sup>175</sup>

The recent disruptions in the U.S. Treasury market referenced above, together with the significant role played

<sup>172</sup> *See supra* notes 165, 170.

<sup>173</sup> *See* Section II.

<sup>174</sup> 2010 Equity Market Structure Concept Release at 3607.

<sup>175</sup> The Commission believes that due to the varying characteristics of the other securities markets, setting a quantitative standard would be more complicated and each market would need to be separately assessed before a quantitative threshold is set. Accordingly, the Proposed Rules do not set forth a comparable quantitative standard for proposed Rule 3a5-4. The Commission is seeking comment, however, on whether proposed Rule 3a5-4 should include a quantitative standard, and if so, how it should be established. *See* Question 26.

<sup>167</sup> *See* Section V.B.2. Specifically, the analysis identified 174 market participants who were active in the U.S. Treasury market in July 2021 and that were not members of FINRA. Although FINRA membership is not synonymous with dealer registration status, the Commission believes that many of the market participants who are not FINRA members are also likely not registered as government securities dealers. These 174 identified non-FINRA member market participants accounted for approximately 19 percent of aggregate Treasury trading volume in July 2021. PTFs had the highest volumes among these identified non-FINRA member U.S. Treasury market participants. *See* Section V.B.2.

<sup>168</sup> *See supra* note 2.

<sup>169</sup> For example, regulators do not have the same insight into the trading activities of unregistered PTFs because, unlike registered dealers, they do not report their U.S. Treasury Securities transactions to FINRA's Trading Reporting and Compliance Engine (“TRACE”), do not file annual reports with the Commission, and are not subject to Commission

by market participants not registered as dealers, distinguishes that market from other markets where these types of participants are more typically registered as dealers. Indeed, it is the Commission's understanding that in the equity markets, because PTF trading strategies typically depend on latency and cost advantages made possible by trading directly (via membership) on a national securities exchange, and the Exchange Act limits exchange membership to registered broker-dealers, there is incentive for many PTFs to register as broker-dealers to gain these advantages.<sup>176</sup> In the U.S. Treasury market, however, where trading occurs on ATs and other non-exchange venues, PTFs lack this incentive to register.

#### Request for Comments

The Commission generally requests comment on this aspect of proposed Rule 3a44-2. In addition, the Commission requests comment on the following specific issues:

17. Is there sufficient specificity provided for the terms used in the quantitative standard? Are there any terms that should be defined in rule text or addressed in the release?

18. Is the threshold of more than \$25 billion of trading volume in each of four out of the last six calendar months an appropriate proxy for determining whether a person is engaged in buying and selling U.S. Treasury Securities for its own account is engaged in such activity as a part of a regular business? Why or why not? If not, what thresholds would be appropriate? For example, should the quantitative standard include a separate trading volume threshold for: (1) Buying; (2) selling; and (3) both buying and selling U.S. Treasury Securities, all three of which would be required to be satisfied in order to meet the quantitative standard? Commenters should provide data to support their views.

19. Should the Commission apply a different look-back period for applying the quantitative threshold from four out of the preceding six months to something different? Is the time period measurement of four out of the last six calendar months an appropriate metric to evaluate a market participant's trading volume? Should the time period be a weekly measurement or is there another measurement that would better determine whether a person is engaged

in buying and selling U.S. Treasury Securities for its own account is engaged in such activity as a part of a regular business?

20. Should the look-back period for the quantitative standard take into consideration the general auction schedule for U.S. Treasury securities? Should the look-back period correspond with the schedule of any particular U.S. Treasury security? Why or why not? For example, the 10-year U.S. Treasury note auctions are usually announced in the first half of February, May, August, and November and generally auctioned during the second week of these months and are issued on the 15th of the same month.<sup>177</sup> Should the look-back period take into consideration these particular months for purposes of the quantitative standard? Why or why not? How could the look-back period incorporate the auction schedule? Please explain.

21. Are there persons that would meet the quantitative standard under the proposed rule but that should not be classified as government securities dealers (*i.e.*, is the quantitative standard over-inclusive?). If so, who are they and why should the Commission not classify them as government securities dealers?

22. Are there persons that would not meet the quantitative standard under the proposed rule—and would not be otherwise captured by the qualitative factors—but that should be classified as government securities dealers based on their trading volume (*i.e.*, is the quantitative standard under-inclusive)? If so, who are they and why should they be classified as government securities dealers?

23. Should the quantitative standard include an additional standard related to routinely expressing trading interests? For example, activity related to resting orders on a central-limit order book, or expressing trading interest on Communication Protocol Systems? If so, what measure of activity, including sources of data and calculation methodology, would appropriately identify market participants as government securities dealers?

24. Are there other ways of calculating a quantitative standard, such as using a measurement based on turnover (*e.g.*, a turnover ratio) rather than volume, or other measurements of significance (*e.g.*, a trading volume ratio, net/gross ratio) that would appropriately identify market participants as government securities dealers? If so, what are they, and why are they relevant in the context of analyzing

dealer status? Commenters should provide any data or information to support their views.

25. Should the quantitative standard be a dynamic trading volume threshold that changes with the market over time, such as percentage of transactions reported to TRACE, a percentage of U.S. Treasury Securities outstanding or issued, or other inflation-adjusted threshold? Why or why not?

26. Should a quantitative standard be included in proposed Rule 3a5-4? To the extent a quantitative standard should be included, are there ways of calculating the standard for other securities markets? Is a trading volume threshold suitable for other types of securities markets?

27. In determining whether the trading volume threshold is met, the Commission has indicated that market participants should exclude auction awards and repurchase or reverse repurchase transactions. Is this exclusion appropriate? Should some or all of these transactions be included? Are there other transactions that should be excluded (*e.g.*, Treasury when-issued transactions)? Please explain. Should any excluded transactions be specifically addressed in rule text? Should there be a similar exclusion of these types of transactions for purposes of evaluating whether a market participant has met the qualitative standards? Are there any types of transactions that should be included in calculating the trading volume amount?

28. Are there market participants that would fluctuate between meeting or not meeting the quantitative standard (or qualitative standard) (*e.g.*, initially meet the standard, a few months later no longer meet the standard, and later meet the standard again)? Would this pattern be associated with a particular type of trading such that there may be periods in which the participant meets neither the quantitative standard nor any qualitative standard?

29. Are there circumstances in which a person triggering the quantitative threshold would not also trigger the proposed qualitative standards? Please describe those circumstances in detail. In such case, would firms implement compliance systems to monitor trading volumes? Do firms have systems in place that already or could easily be programmed to monitor for the proposed quantitative threshold? What are the costs of implementing such systems or updating existing systems? Would firms be incentivized to trade below the proposed quantitative standard to avoid registration?

<sup>176</sup> See 15 U.S.C. 78f(c)(1) ("A national securities exchange shall deny membership to (A) any person, other than a natural person, which is not a registered broker or dealer or (B) any natural person who is not, or is not associated with, a registered broker or dealer.").

<sup>177</sup> See TreasuryDirect, General Auction Timing, available at <https://www.treasurydirect.gov/instit/auctfund/work/auctime/auctime.htm>.

*D. Definitions of “Own Account” and “Control”*

The Exchange Act defines a “dealer” or “government securities dealer” as a person engaged in the business of buying and selling securities for its “own account.”<sup>178</sup> The Proposed Rules define a person’s “own account” in a way that recognizes that corporate families and entities may be organized in various structures. The proposed definitions of “own account” and “control” are designed to focus on the trading activity occurring at the firm or legal-entity level or the trading activity that is being employed on behalf of, or for the benefit of, the entity, and limit the registration burden to those entities engaged in dealer activity. In addition, the proposed definitions are intended to avoid incentivizing market participants to change their corporate structures for the purpose of avoiding registration.

Under paragraph (b)(2) of the Proposed Rules, a person’s “own account” means any account that is: “held in the name of that person”; or “held in the name of a person over whom that person exercises control or with whom that person is under common control, provided that this paragraph (b)(2)(ii) does not include [the accounts described in paragraphs (b)(2)(ii)(A)–(C)]”; or “held for the benefit of those persons identified in paragraphs (b)(2)(i) and (ii).”<sup>179</sup> Paragraphs (b)(2)(ii)(A)–(C) excludes an account in the name of a registered broker, dealer, or government securities dealer, or an investment company registered under the Investment Company Act of 1940; with respect to an investment adviser registered under the Investment Advisers Act of 1940, an account held in the name of a client of the adviser unless the adviser controls the client as a result of the adviser’s right to vote or direct the vote of voting securities of the client, the adviser’s right to sell or direct the sale of voting securities of the client, or the adviser’s capital contributions to or rights to amounts upon dissolution of the client; and with respect to any person, an account in the name of another person that is under common control with that person solely because both persons are clients of an investment adviser

<sup>178</sup> 15 U.S.C. 78c(a)(5) (“The term ‘dealer’ means any person engaged in the business of buying and selling securities . . . for such person’s own account through a broker or otherwise.”) (emphasis added); 15 U.S.C. 78c(a)(44) (“The term ‘government securities dealer’ means any person engaged in the business of buying and selling government securities for his own account, through a broker or otherwise . . .”) (emphasis added).

<sup>179</sup> See proposed Rule 3a5–4(b)(2) and proposed Rule 3a44–2(b)(2).

registered under the Investment Advisers Act of 1940 unless those accounts constitute a parallel account structure.<sup>180</sup>

With respect to which accounts should be aggregated for purposes of paragraph (b)(2)(ii), the Proposed Rules would incorporate the definition of “control” under Exchange Act Rule 13h–1.<sup>181</sup> The Commission believes that incorporating the established definition of “control” under Exchange Act Rule 13h–1 into the Proposed Rules would promote consistency and assist persons in applying the definition. The Commission further believes that the proposed definition of “control” is sufficiently limited to capture only those market participants with a significant enough controlling interest to warrant registration as a dealer.<sup>182</sup> The proposed definition of “control” used in Rule 13h–1 is appropriate because it is less burdensome than other Commission rules defining control, but still achieves the goal of identifying persons who exert direct or indirect control over significant market participants.<sup>183</sup> In addition, the Commission believes that this definition

<sup>180</sup> See proposed Rule 3a5–4(b)(2)(ii)(A)–(C) and proposed Rule 3a44–2(b)(2)(ii)(A)–(C).

<sup>181</sup> Exchange Act Rule 13h–1(a)(3) provides that control (including the terms controlling, controlled by and under common control with) means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of securities, by contract, or otherwise. For purposes of Rule 13h–1 only, any person that directly or indirectly has the right to vote or direct the vote of 25 percent or more of a class of voting securities of an entity or has the power to sell or direct the sale of 25 percent or more of a class of voting securities of such entity, or in the case of a partnership, has the right to receive, upon dissolution, or has contributed, 25 percent or more of the capital, is presumed to control that entity. 17 CFR 240.13h–1(a)(3). The definition of “control” in Rule 13h–1 is based on the definition of “control” in Form 1 (Application for the Registration or Exemption from Registration as a National Securities Exchange) and Form BD (Uniform Application for Broker-Dealer Registration).

<sup>182</sup> As noted above, the Commission has applied this standard in other contexts. See Large Trader Reporting, Exchange Act Release No. 61908 (Apr. 14, 2010), 75 FR 21456, 21461 (Apr. 23, 2010) (“The Commission preliminarily believes that the proposed definition of control is sufficiently limited to capture only those persons with a significant enough controlling interest to warrant identification as a large trader.”). The definition of “control” in Rules 13h–1 and on Forms 1 and BD is less expansive than the definition of control as used in 17 CFR 240.19h–1 (Rule 19h–1), for example. In Rule 19h–1(f)(2), the definition of “control” features a 10 percent threshold with respect to the right to vote 10 percent or more of the voting securities or receive 10 percent or more of the net profits.

<sup>183</sup> The Commission is not incorporating the provision contained in the Form 1 and Form BD relating to directors, general partners, or officers that exercise executive responsibility. Instead, the proposed definition of “control” focuses on the existence of a corporate control relationship over significant market participants.

of control would appropriately deter the structuring of corporate relationships or establishment of multiple legal entities to avoid the Proposed Rules.

The Proposed Rules exclude three types of accounts from being aggregated with another account for purposes of the definition of “own account.” First, under paragraph (b)(2)(ii)(A), where an account is held in the name of a person who is a registered broker, dealer, government securities dealer, or registered investment company (collectively, “registered person”), the Commission believes that it would be inappropriate to attribute the registered person’s accounts to controlling persons or persons under common control, because the registered person is already subject to the broker-dealer regulatory regime or the investment company regulatory regime.<sup>184</sup> Thus, the definition of “own account” would not include those types of accounts.

Second under paragraph (b)(2)(ii)(B), the Proposed Rules would not attribute to a registered investment adviser an account held in the name of a client of the adviser, unless the adviser controls the client as a result of the adviser’s right to vote or direct the vote of voting securities of the client, the adviser’s right to sell or direct the sale of voting securities of the client, or the adviser’s capital contributions to or rights to amounts upon dissolution of the client.<sup>185</sup>

Under the aggregation provisions of the Proposed Rules, a registered investment adviser that has an investment advisory relationship and is determined to control the client would be required to aggregate its trading activities with those of the client.<sup>186</sup> The

<sup>184</sup> As discussed in Section I.I.A, the Proposed Rules would exclude registered investment companies in light of the regulatory framework that applies under the Investment Company Act and rules thereunder.

<sup>185</sup> Registered investment advisers typically have investment discretion over the assets of the accounts of their clients, including private funds and other client accounts that are managed separately (“separately managed accounts”). Each of these clients has its own independent investment objectives and strategies, which the registered investment adviser implements as agent for the client. Moreover, investors in different private funds typically differ in their investment objectives and strategies, as do owners of the assets in separately managed accounts. A registered investment adviser has a duty to provide investment advice in the best interest of its client, based on the client’s investment objectives, see Investment Advisers Act Release No. 5248 (June 5, 2019), 84 FR 33669, 33671 (July 12, 2019), and so the Proposed Rules would not require aggregation solely because a registered investment adviser exercises discretion.

<sup>186</sup> For purposes of the Proposed Rules “control” is defined to include “the possession, direct or indirect, of the power to direct or cause the direction of the management and policies whether

Proposed Rules' aggregation provisions are designed to account for trading activity within a corporate family in which trading activity at a firm or legal-entity level is employed on behalf of or for the benefit of another legal entity. In the case of registered investment advisers that have no controlling ownership interest in an entity for which they are solely managing client assets, the trading activities of the adviser and each client are independent of each other and are not for the benefit of the adviser or any other client. Nevertheless, the Commission recognizes, in the absence of the proposed exclusion for such accounts, questions could arise whether the Proposed Rules could require the aggregation of client trading activities with those of the registered investment adviser. Because some clients may have similar trading strategies, their trading activities in the aggregate could meet the proposed qualitative or quantitative standards. This would result in the application of the Proposed Rules to the activities of a registered investment adviser and those of its clients even when none of the entities is engaged in dealer activity for the economic benefit of another. To reduce the potential for capturing registered investment advisers and their clients in these circumstances, we are proposing to exclude registered investment advisers from aggregating their trading activities with those of their clients when the adviser and client only have a discretionary investment management relationship (*i.e.*, where the registered investment adviser does not control the client as a result of the adviser's right to vote or direct the vote of voting securities of the client, the adviser's right to sell or direct the sale of voting securities of the client, or the adviser's capital contributions to or rights to amounts upon dissolution of the client).<sup>187</sup>

The Proposed Rules, however, are designed to address situations in which a registered investment adviser might use the proposed exclusion to avoid the application of the Proposed Rules. For example, a registered investment adviser that has a controlling ownership interest in a client could attempt to divide trading activities among several clients it controls to avoid dealer registration by any individual client whose trading activities would meet either of the Proposed Rules. In those circumstances, the aggregate trading

through the ownership of securities, by contract or otherwise." See *supra* note 181; 17 CFR 240.13h-1(a)(3).

<sup>187</sup> See text in 3a5-4(b)(2)(ii)(B) and 3a44-2(b)(2)(ii)(B) of the Proposed Rules.

activities of each client could be designed to economically benefit the registered investment adviser and, if aggregated, the activities would fall within the intended scope of the Proposed Rules. To prevent such potentially evasive structures, the proposed exclusion from aggregation does not apply to any registered investment adviser that controls the client as a result of the registered investment adviser's right to vote or direct the vote of voting securities of the client, the registered investment adviser's right to sell or direct the sale of voting securities of the client, or the adviser's capital contributions to or rights to amounts upon dissolution of the client.<sup>188</sup>

Third, under paragraph (b)(2)(ii)(C), a person under common control with another person solely because both persons are clients of a registered investment adviser would not aggregate their trading activities and volume to determine if each meet the Proposed Rules, unless those accounts constitute a parallel account structure. The Proposed Rules would define parallel account structure to mean "a structure in which one or more private funds (each a 'parallel fund'), accounts, or other pools of assets (each a 'parallel managed account') managed by the same investment adviser pursue substantially the same investment objective and strategy and invest side by side in substantially the same positions as another parallel fund or parallel managed account."<sup>189</sup> The aggregation provisions would require clients of a registered investment adviser that are determined to be under "common control" of the registered investment adviser to aggregate their trading activities under certain circumstances. As noted above, in many instances, a registered investment adviser's clients are engaged in independent investment objectives and strategies and no individual client is engaged in trading activities for the benefit of any other client. As a result, in the absence of the proposed exclusion, questions could arise whether clients who would not otherwise be scoped into the Proposed Rules either because of their individual trading activities or their trading activities for the economic benefit of

<sup>188</sup> *Id.* Paragraph (b)(2)(ii)(B) reflects the definition of control under Exchange Act Rule 13h-1. See 17 CFR 240.13h-1(a)(3).

<sup>189</sup> See proposed Rule 3a5-4(b)(4) and proposed Rule 3a44-2(b)(4). The proposed definition of "parallel account structure" corresponds to definitions of "parallel fund structure" and "parallel managed account" under Form PF. See Form PF Glossary of Terms, available at <https://www.sec.gov/files/formpf.pdf>.

any other client, could nevertheless be captured by the Proposed Rules as a result of having to aggregate their trading activities with those of other clients. To reduce the potential for capturing these registered investment adviser clients in these circumstances, we are proposing to exclude from the proposed requirement to aggregate trading activities of clients of a registered investment adviser that are under common control solely because both are clients of the same registered investment adviser.<sup>190</sup>

At the same time, however, the Proposed Rules are designed to prevent a registered investment adviser from dividing trading activities among multiple clients to avoid the application of the Proposed Rules. A registered investment adviser could, for example, create a parallel fund structure in which one or more private funds pursue substantially the same investment objective and strategy and invest side by side in substantially the same positions as another private fund. The registered investment adviser could limit the trading activity of each "parallel fund" so that individually it does not meet the qualitative or quantitative standards, even though the funds' trading activities in the aggregate are part of a single trading strategy. To prevent such potential structuring of funds to avoid dealer registration, the proposed exclusion would not apply to client accounts that constitute a parallel account structure.<sup>191</sup>

Finally, it is important to note that, as discussed above, while a person that meets the qualitative or quantitative standards in paragraph (a) is not subject to the Proposed Rules if that person has or controls total assets less than \$50 million,<sup>192</sup> the accounts of such under-\$50-million persons must be considered for purposes of determining whether another person's trading activities or volume falls within the qualitative or quantitative standards set forth in paragraph (a). In particular, a person must consider for aggregation purposes any accounts (including those under \$50 million) that are controlled by, or under common control with, that person. The Commission believes that requiring aggregation of accounts of those persons that have or control less than \$50 million in total assets would prevent the organizing of corporate

<sup>190</sup> See proposed Rule 3a5-4(b)(2)(ii)(C) and proposed Rule 3a44-2(b)(2)(ii)(C).

<sup>191</sup> *Id.*

<sup>192</sup> See Section III.A; proposed Rule 3a5-4(a)(2)(i) and proposed Rule 3a44-2(a)(3)(i).

structures for the purpose of avoiding dealer registration.

The following examples illustrate the application of the Proposed Rules' definition of "own account" as discussed above. In these examples, whether any of the firms' relationship and activities meet the definition of "control" would remain a facts and circumstances determination. Additionally, as discussed in Section III.E, although a firm may not meet the Proposed Rule's definition of dealer or government securities dealer in the examples, the firm may be a dealer or government securities dealer pursuant to existing Commission interpretations and precedent to the extent consistent with the Proposed Rules.

#### Example 1

- A, B, and C are under common control; all are controlled by D. A, B, C, and D are all limited liability companies. None of the firms are registered brokers, dealers, government securities dealers, or registered investment companies.

#### Aggregation by Parent D

- D would aggregate the trading activities and volume of A, B, C, and D to determine if D would be captured by paragraph (a) of the Proposed Rules. If as a result of this aggregation, D meets the quantitative or qualitative standards of paragraph (a), and it has or controls more than \$50 million in total assets, it would be captured by the Proposed Rules.

#### Aggregation by D's Subsidiaries

- A, B, and C would also need to aggregate each other's trading activities and volume to determine if they would individually be captured by the qualitative or quantitative standards of paragraph (a) of the Proposed Rules. If, as a result of aggregation A, B, and C each meet the qualitative or quantitative standards of paragraph (a), but A has or owns less than \$50 million in total assets, A would be excluded from the Proposed Rules under paragraph (a). A's activities and volume, however, would still be considered for purposes of B, C, and D.

- If B registers as a dealer, its trading activities and volume would no longer be considered by A, C, or D.

#### Example 2

- A is a registered investment adviser with clients B, C, D, E, F, and G. A has an investment advisory contract with each of B and C under which A exercises investment discretion with respect to B's and C's assets each in an account separately managed by A. D and

E are hedge funds. A is the general partner of both D and E, and controls D and E as a result of its capital contributions to and rights to amounts upon dissolution of each fund. F and G are also hedge funds. A has an investment advisory contract with each of F and G under which A exercises investment discretion with respect to F's and G's assets. F and G pursue substantially the same investment objective and strategy and invest side by side in substantially the same positions. Neither A nor any of its clients is a registered broker, dealer, government securities dealer, or registered investment company.

#### Aggregation by A

- A would not need to aggregate its trading activities with the trading activities of B, C, F, or G unless A controls B, C, F, or G as a result of the right to vote or direct the vote of the voting securities issued by these clients, the right to sell or direct the sale of the voting securities issued by these clients, or the amount of capital contributions to or rights to amounts upon these clients' dissolution.

- A would need to aggregate its trading activities with the trading activities of both D and E because A has control over each fund as a result of its capital contributions to and rights to amounts upon dissolution of each fund.

#### Aggregation by A's Clients

- B and C would not need to aggregate their trading activities even if B and C were determined to be under common control (which would be a facts and circumstances determination), because common control would be solely because both are clients of A.

- D and E would need to aggregate their trading activities because they are under common control of A, which has the right to direct the vote of the voting securities of each fund and the right to capital contributions upon dissolution of the fund and not solely because each fund is a client of A.

- Each of F and G would need to aggregate the trading activities of the other fund. F and G's activities would constitute a parallel account structure (even if they are under common control solely because both F and G are clients of A) because F and G are managed by the same investment adviser, pursue substantially the same investment objective and strategy and invest side by side in substantially the same positions as another parallel fund or parallel managed account.

The Commission believes that the definitions of own account and control are appropriate and will help to ensure

that there is no circumvention of the Proposed Rules through, for example, the establishment of multiple legal entities whose activities may not separately rise to a level of engagement that qualifies for dealer or government dealer status, but, when aggregated, does demonstrate that the entities are selling and buying securities or government securities as a part of a regular business.

#### Request for Comments

The Commission generally requests comment on this aspect of the Proposed Rules. In addition, the Commission requests comment on the following specific issues:

30. Does the proposed definition of "own account" appropriately reflect complexities and differences in corporate structures and business models of proprietary trading firms, investment advisers, private funds, and other market participants, and the ownership structures of their trading accounts? Why or why not? Commenters should provide descriptions to support their responses.

31. Except as described in paragraph (b)(2)(ii), are there instances when an account of a controlled person, or person under common control, should not be considered a person's "own account" for purposes of the Proposed Rules? For example, should an account held in the name of a bank be excluded from the definition of "own account"? Commenters should provide descriptions of any such instances.

32. Is the proposed definition of "control" appropriate? What is the effect of using the Exchange Act definition of "control", as opposed to the Investment Company Act definition? Please describe potential alternative definitions and why they are more appropriate.

33. Are there instances where two entities may meet the proposed definition of "control" and where these entities are in different lines of business and/or unaware of the other's trading strategies? Are there any situations where two entities may meet the proposed definition of "control" but communications between two entities would be prohibited?

34. Under the Proposed Rules, a registered investment adviser would aggregate its account with its client accounts (private funds and separately managed accounts), except as described in paragraph (b)(2)(ii).

- Should registered investment advisers be included only with respect to their own proprietary trading activities (*i.e.*, not with respect to activities that could be attributed to

them by the aggregation contemplated by the definitions of “own account” and “control”? Why or why not?

- How would such aggregated accounts comply with the requirements for dealer registration?

- In these cases, would the investment adviser registering itself avoid registering a private fund or separately managed account client? If not, are there other actions these accounts would seek to take to avoid all such accounts either registering as dealers or ceasing investment strategies that trigger the Proposed Rules application? Would any of such accounts avoid certain investment strategies to prevent application of the Proposed Rules? If so, which investment strategies and at which types of accounts?

- Would the registered investment adviser restructure its activities or those of its private fund or separately managed account clients to avoid registering a private fund or separately managed account client as a dealer? For example, would a registered investment adviser create an affiliated broker-dealer to avoid registering itself and/or any clients as dealers? What would be the effects of any restructuring? Please explain.

35. Should the Proposed Rules require registered investment advisers to aggregate client accounts when the adviser controls a person other than through an ownership interest? Why or why not? We understand that, for tax and other purposes, hedge fund offshore companies are often controlled by boards of directors or legal entities that are separate from the hedge fund’s adviser. Should the aggregation provisions of the Proposed Rules cover those arrangements? Will the exclusion in paragraph (b)(2)(ii)(B) have different impacts on registered investment adviser client funds that are organized domestically as general partnerships and funds that are organized offshore as companies with independent directors? If so, could registered investment advisers restructure certain funds to avoid application of the Proposed Rules? What would be the effects of any restructuring? Would a registered investment adviser’s use of an omnibus account to trade client securities on an aggregate basis present particular interpretative questions or raise operational issues for these purposes?

36. Should registered investment adviser clients that are under common control solely because they are clients of the same registered investment adviser be required to aggregate accounts? Why or why not? Does the definition of “parallel control structure” adequately

capture ways in which a registered investment adviser could seek to separate trading activities among accounts to avoid registration by their clients? Would the aggregation provisions of the Proposed Rules appropriately capture activity that would raise the concerns that the Proposed Rules are designed to address? Would the aggregation provisions of the Proposed Rules capture activity that it should not? If so, please explain.

37. Are there any incentives created by the aggregation provisions that may cause market participants to reevaluate or restructure their corporate structures? What costs and benefits are there associated with restructuring?

38. Would market participants exit certain strategies or exit the market to avoid registration? If so, what would be the effects?

#### *E. No Presumption*

The Proposed Rules would further define the phrase “as a part of a regular business” by identifying certain activities that would cause persons engaging in such activities to be “dealers” or “government securities dealers” within the meaning of Sections 3(a)(5) and 3(a)(44) of the Exchange Act.<sup>193</sup> They would not seek to address all persons that may be acting as dealers or government securities dealers under otherwise applicable interpretations and precedent.<sup>194</sup> A person that does not meet the conditions set forth in the Proposed Rules may nonetheless be a dealer if it is otherwise engaged in a regular business of buying and selling securities for its own account by, for example, acting as an underwriter.<sup>195</sup>

To emphasize this point, the Proposed Rules would state that no presumption shall arise that a person is not a dealer or government securities dealer as defined by the Exchange Act solely because that person does not satisfy paragraph (a) of the Proposed Rules. Proposed Rules 3a5–4(c) and 3a44–2(c) thus would provide that a person may

<sup>193</sup> As discussed above, each qualitative standard in proposed Rules 3a5–4 and 3a44–2 is a separate definition that further defines when a person is acting as a dealer or government securities dealer. See Section III.B. Accordingly, a person would register with the Commission if it satisfied any one of the three qualitative standards. *Id.* Similarly, the quantitative standard in proposed Rule 3a44–2(a)(2) is a discrete definition and a person would register as a government securities dealer upon meeting this standard even if it did not satisfy any of the qualitative standards in proposed Rule 3a44–2(a)(1). See Section III.C.

<sup>194</sup> See *supra* note 87; see, e.g., 2002 Release at 67499 (stating that “[a]s developed over the years, the dealer/trader distinction recognizes that dealers normally . . . hold themselves out as buying and selling securities at a regular place of business”).

<sup>195</sup> See 2002 Release at 67499.

still meet the statutory definition of dealer and government securities dealer even absent the activity identified in paragraph (a) of the Proposed Rules if the person is otherwise engaged in buying and selling securities or government securities for its own account as a part of a regular business.<sup>196</sup>

#### **IV. General Request for Comments**

The Commission generally requests comment on all aspects of the Proposed Rules. In addition, the Commission requests comment on the following specific issues:

39. Are there standards of activity other than the standards under the Proposed Rules that the Commission should apply in the context of analyzing dealer status? If so, which standards and why?

40. Would the Proposed Rules capture persons that should not be regulated as dealers? If so, who? Why would they be captured under the Proposed Rules, and why is that not appropriate?

41. Are there any categories of persons that would not meet the Proposed Rules, yet should be registered as dealers? Commenters should identify any such categories of persons and describe why they should be registered despite not meeting the proposed thresholds.

42. Would the Proposed Rules cause market participants to reevaluate or restructure their activities to avoid registration as a dealer or cease investment strategies that trigger the application of the Proposed Rules? What would be the effects of such restructuring, withdrawal, or cessation? Please explain.

43. For purposes of determining whether a person is a dealer, are there significant differences between equity securities, government securities, or other securities that should be addressed by the Proposed Rules? Commenters should identify and discuss any such differences.

44. Would the Proposed Rules appropriately apply the requirements applicable to dealers (e.g., capital, margin, and business conduct requirements) to the entities that would be subject to those requirements? Is the scope of the Proposed Rules appropriate in light of the costs and benefits associated with those substantive rules?

45. How are each of PTFs, hedge funds, and investment advisers typically capitalized? Would the requirement of the Net Capital Rule (Exchange Act Rule 15c3–1) deter any of these entities from

<sup>196</sup> See proposed Rule 3a5–4(c) and proposed Rule 3a44–2(c).

registering? Would the Net Capital Rule cause these entities to alter trading activity that would trigger the rules' application?

46. Would a pension plan or other institutional investor that rebalances its portfolio be captured by the Proposed Rules? Please explain how. If so, should the rule specifically exclude periodic portfolio rebalancing (*e.g.*, on a monthly or quarterly basis) from the concept of "as a part of a regular business?" Why or why not?

47. Should the Commission view rebalancing differently if it occurs only at a certain frequency or by certain institutional investors? Why or why not?

48. Are there any other terms used in the Proposed Rules that the Commission should define? Why or why not? Please identify what term(s) and how the term(s) should be defined.

49. Should the Proposed Rules include an anti-evasion provision similar to Rule 13h-1(c)(2), and why?

50. Will the Proposed Rules appropriately account for trading activity occurring through sponsored access arrangements? Is there anything more that the Commission should address regarding how such Proposed Rules will interrelate with such arrangements?

51. If the Proposed Rules are adopted, which staff letters, if any, should or should not be withdrawn, and why?

52. Are there additional standards, consistent with the Commission's objectives, that should be incorporated into the Proposed Rules? Commenters should identify and discuss any such standards.

53. Are there any additional factors that the Commission should address in relation to the Proposed Rules?

54. Are there any alternative approaches to the Proposed Rules that the Commission should propose? Commenters should identify any such alternative approach and describe the advantages and disadvantages of the alternative approach.

55. Other than what is discussed herein, are there any costs of compliance with the Proposed Rules that the Commission has not addressed? Commenters should describe any additional costs of compliance with the proposed rule and include any empirical data, to the extent available.

56. The Commission is proposing a one-year compliance period from the effective date of any final rules if adopted. Would the proposed compliance period provide sufficient time for market participants to comply with the Proposed Rules? Why or why not?

## V. Economic Analysis

### A. Introduction

The Commission is sensitive to the economic effects of its rules, including the costs and benefits and effects on efficiency, competition, and capital formation. Section 3(f) of the Exchange Act requires the Commission, whenever it engages in rulemaking pursuant to the Exchange Act and is required to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action would promote efficiency, competition, and capital formation.<sup>197</sup> In addition, Section 23(a)(2) of the Exchange Act requires the Commission, when making rules under the Exchange Act, to consider the effect such rules would have on competition.<sup>198</sup> Exchange Act Section 23(a)(2) prohibits the Commission from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.<sup>199</sup>

The Commission believes the Proposed Rules will support orderly markets and protect investors by addressing negative externalities that may arise in relation to market participants' financial and operational risks. The Proposed Rules would also improve transparency in markets. Specifically, the Commission believes the Proposed Rules would promote the financial and operational resilience of individual liquidity providers in securities markets and would improve the Commission's ability to monitor market activity, conduct research, and detect manipulation and fraud. The Proposed Rules would have uncertain impacts on efficiency, competition, and capital formation, due to the likelihood of offsetting effects. As discussed further below, the Proposed Rules may create a more level competitive landscape by applying similar rules to all activities that meet the proposed standards, and they may also promote market efficiency and capital formation by strengthening market stability and investor protection. However, offsetting effects could arise due to costs that the Proposed Rules would impose on activities that provide liquidity.

Any person whose activities satisfy the qualitative or quantitative standards would be affected by the Proposed Rules. The list of affected parties would primarily include PTFs, but private funds may also be affected. Registered

investment advisers may be affected if their own proprietary trading activity triggers the application of the Proposed Rules or if they have certain control over client accounts (including private funds and separately managed accounts) that, individually or collectively, engage in activities that satisfy the Proposed Rules. However, the Proposed Rules' aggregation provisions exclude an account held in the name of a client of the registered investment adviser unless the adviser controls the client as a result of the adviser's right to vote or direct the vote of voting securities of the client, the adviser's right to sell or direct the sale of voting securities of the client, or the adviser's capital contributions to or rights to amounts upon dissolution of the client.<sup>200</sup> Registered investment companies would be excluded from the Proposed Rules, along with all persons that have or control assets of less than \$50 million, as described below. Other parties who may be indirectly affected include the competitors, customers or clients (if any), and creditors (if any) of the above-mentioned affected parties.

### B. Baseline

Dealers perform an important market function, absorbing order imbalances and providing liquidity to buyers and sellers who may not arrive at the same time, and a regulatory regime exists to govern their activities. However, market participants that do not register as dealers—and so are not required to comply with the dealer regulatory regime—increasingly perform similar economic functions as dealers. This difference in regulatory treatment creates the potential for negative externalities, as described below. Furthermore, the unevenness of regulation potentially places a greater burden on registered dealers than on other market participants that engage in similar activities, which may allow market participants not registered as dealers to gain market share from registered dealers.

#### 1. Regulatory Baseline

Dealers, unless excepted or exempted, are required to register with the Commission,<sup>201</sup> join an SRO, and adhere to a comprehensive regulatory regime. As discussed above in Section II, this regime includes provisions that limit risk (*e.g.*, the Net Capital Rule and rules promoting operational integrity),

<sup>197</sup> See *supra* note 185 and associated text.

<sup>201</sup> As of August 2, 2021, 3,559 firms were registered with the Commission as broker-dealers. See *Data: Company Information About Active Broker-Dealers*, SEC (updated Feb. 1, 2022), available at <https://www.sec.gov/help/foiaodoc/sbdfjoiahtm.html>.

<sup>197</sup> 15 U.S.C. 78c(f).

<sup>198</sup> 15 U.S.C. 78w(a)(2).

<sup>199</sup> *Id.*

books and records requirements,<sup>202</sup> various reporting and disclosure requirements,<sup>203</sup> and dealer-specific anti-manipulative and other anti-fraud rules.<sup>204</sup> The Net Capital Rule (Rule 15c3-1) requires registered dealers to maintain minimum amounts of net liquid assets at all times, even intraday, thus constraining dealer leverage.<sup>205</sup> In addition to the financial and regulatory risk management controls required by the Market Access Rule, broker-dealers with market access must comply with a number of underlying regulatory requirements when conducting their business.<sup>206</sup> Registered dealers are also subject to the Commission's authority to conduct examinations and impose sanctions,<sup>207</sup> and to the examination and enforcement authority of the relevant SRO.<sup>208</sup> Government securities dealers are further subject to rules issued by the Treasury that concern financial responsibility, capital requirements, recordkeeping, reports and audits, and large position reporting.<sup>209</sup> Finally, since registered

dealers must join an SRO, they are bound by additional rules set by the SROs.<sup>210</sup>

Among other things, these rules help to ensure that dealers are financially responsible, including adequately capitalized, that they maintain internal controls, and that the Commission and the SROs have tools to help them detect manipulation or fraud by analyzing transaction reports and examining other records kept by the dealer.

## 2. Other Market Participants

Market participants who are not registered as dealers also conduct significant activity in securities markets,<sup>211</sup> and the Commission believes that some of these entities nevertheless perform the economic function of dealers. Because the Proposed Rules would apply to activities rather than persons' legal descriptions or other characteristics, they could potentially capture a wide array of persons.<sup>212</sup>

The list of affected parties would not include persons who have or control assets less than \$50 million, and we estimate that this provision would exclude the majority of investors.<sup>213</sup>

<sup>210</sup> For example, see FINRA Rule 2010 (Standards of Commercial Honor and Principles of Trade); FINRA Rule 2020 (Use of Manipulative, Deceptive, or Other Fraudulent Devices); and FINRA Rule 4510 Series (Books and Records Requirements). Other SROs have comparable and sometimes equivalent rules. See, e.g., *NYSE Rules*, NYSE, available at <https://nyseguide.srorules.com/rules>, *Rulebook—The Nasdaq Stock Market*, Nasdaq, available at <https://listingcenter.nasdaq.com/rulebook/nasdaq/rules>.

<sup>211</sup> For fixed income securities, where TRACE data allow us to observe some of the activity of non-dealers, we estimate that in July 2021 the combined volume of non-FINRA firms accounted for approximately 45 percent of the volume of U.S. Treasury securities, approximately 44 percent of the total corporate bond volume, and approximately 42 percent of the volume of agency pass-through mortgage backed securities (including securities traded in specified pool transactions and securities traded to be announced). While FINRA membership is not synonymous with dealer registration status, the Commission believes that many non-FINRA entities are also not registered as dealers.

<sup>212</sup> Upon the adoption of any final rule, some letters and other staff statements, or portions thereof, may be moot, superseded, or otherwise inconsistent with the final rules and, therefore, would be withdrawn or modified. See *supra* note 41.

<sup>213</sup> Most U.S. investors are households, and most household investors have less than \$50 million in

Established FINRA rules distinguish retail investors from institutional investors, in part, based on a threshold of \$50 million in assets, and we follow that standard to exclude small investors who are unlikely to conduct a significant degree of dealer-like activity.<sup>214</sup> Certain financial institutions may also be exempt from the Proposed Rules.<sup>215</sup>

The first two subsections below explain why we preliminarily believe that PTFs and private funds, particularly hedge funds, are the most likely firms other than registered dealers to be engaged in activities that would satisfy the Proposed Rules. As discussed above, the activities of clients would not be attributed to a registered investment adviser for purposes of determining whether the adviser would fall under the Proposed Rules, except in cases where (i) the adviser controls the clients as a result of voting rights, capital contributions, or the rights to amounts upon dissolution and (ii) the clients over which the registered adviser has such control collectively engage in activities that satisfy the Proposed Rules. Therefore, registered investment advisers would not fall under the Proposed Rules solely due to client activities over which the adviser has investment discretion. Advisers may still fall under the Proposed Rules on the basis of their own proprietary trading. The third subsection below discusses evidence regarding the number of persons whose activities may satisfy the Proposed Rules. The final subsection covers the Proposed Rules' exclusion for registered investment companies.

assets. The 2019 Survey of Consumer Finance, sponsored by the Federal Reserve Board of Governors and the U.S. Treasury, shows that 68 million U.S. families owned stocks and bonds, either directly or indirectly, and that 93 percent own less than \$1 million. The survey also showed that the mean (median) U.S. household had total assets of \$858,000 (\$227,000). This number of household investors is much larger than the number of institutional investors. For example, there are currently 16,127 registered investment companies and 14,874 registered investment advisers.

<sup>214</sup> See *supra* note 99.

<sup>215</sup> See *supra* notes 9 and 29.

<sup>202</sup> See *supra* note 79.

<sup>203</sup> See *supra* note 77.

<sup>204</sup> See *supra* note 80.

<sup>205</sup> See *supra* note 76. Rule 15c3-1 requires dealers to maintain, at all times, net capital above the greater of: A percentage of debt (6.25 percent, or 11.1 percent for 12 months after commencing business as a broker or dealer), or a fixed minimum amount based on the types of business in which the dealer engages (the general amount for dealers without customers is \$100,000).

<sup>206</sup> 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).

<sup>207</sup> See *supra* note 82 and Section II.D.

<sup>208</sup> Exchange Act Section 17(b) subjects broker-dealers to inspections and examinations by Commission staff and by the relevant SRO. In addition, 17 CFR 240.15b2-2 (Exchange Act Rule 15b2-2) generally requires the SRO that has responsibility for examining a dealer member to inspect a newly registered dealer for compliance with applicable financial responsibility rules within six months of registration, and for compliance with all other regulatory requirements within 12 months of registration. See also 17 CFR 240.17d-1 (Exchange Act Rule 17d-1), Examination for compliance with applicable financial responsibility rules. Thereafter, FINRA or another SRO, as applicable, continues to inspect each firm periodically, based on the firm's risk profile.

<sup>209</sup> See *supra* note 81.

### a. Proprietary Trading Firms

PTFs have emerged as consequential players in securities markets. While some PTFs have registered with the Commission, many others have not. Some studies of high-frequency trading—a primary feature of PTF activity, according to the 2015 Joint Staff Report—show that this activity may have positive effects on transaction costs and competition, while other studies show that the net effects may be negative.<sup>216</sup> PTFs that are not registered

<sup>216</sup> For a survey of the literature, see, Albert J., 2016, *The Economics of High-Frequency Trading: Taking Stock, Annual Review of Financial Economics* (8), 1–24. See also Baron, Matthew, Jonathan Brogaard, Björn Hagströmer, and Andrei Kirilenko, 2019, Risk and Return in High-Frequency Trading, *Journal of Financial and Quantitative Analysis* 54(3), 993–1024.

<sup>217</sup> The analysis is limited to a subsection of TRACE data where the identity of trading counterparties is known. In July 2021, approximately 58 percent of the non-FINRA member volume in TRACE belonged to anonymous market participants. Non-FINRA member participants generally appear anonymously when they trade with FINRA members, who report their activity to TRACE but maintain the anonymity of the non-FINRA member counterparties. When non-FINRA member participants trade on an ATS that is covered by FINRA Rule 6730.07, the ATS reports the transaction to TRACE along with a unique, non-anonymous MPID for each counterparty.

<sup>218</sup> TRACE identifies counterparties by MPIDs, of which an individual firm may have many. The firm classification is based on an understanding of the

with the Commission are subject to the anti-manipulation and anti-fraud provisions under Securities Act Section 17(a) and to Exchange Act Section 10(b), but they are not subject to the more targeted provisions under Exchange Act Section 15(c), to examinations, to net capital requirements, or to various reporting requirements that apply to dealers.

Because regulatory TRACE data pertaining to Treasury securities reported by certain ATSs contains the identity of non-FINRA member trading parties, we are able to analyze PTFs' importance in the U.S. Treasury market during July 2021<sup>217</sup> and summarize the number and type of market participants by monthly trading volume in Table 1 below.<sup>218</sup> The analysis included 626 firms<sup>219</sup> who were active in the U.S. Treasury market in July 2021, of which 452 were FINRA members and 174 were not. While FINRA membership is not

individual firms' businesses (see also the 2015 Joint Staff Report at 50).

<sup>219</sup> The analysis does not aggregate affiliated firms, but counts them separately, even though they may be controlled by a common corporate parent. For example, if a firm were to have a FINRA-member broker-dealer affiliate and a non-FINRA hedge fund affiliate, the analysis would consider the broker-dealer and the hedge fund as separate firms.

<sup>220</sup> See *supra* note 2. See also FEDS Notes, "Unlocking the Treasury Market Through TRACE" (Sept. 28, 2018).

synonymous with dealer registration status, we believe that many of the large participants in the U.S. Treasury market who are not FINRA members are also not registered as dealers. The 174 identified non-FINRA member firms in Table 1 accounted for approximately 19 percent of aggregate Treasury trading volume in July 2021. PTFs had by far the highest volumes among identified non-FINRA member participants in the U.S. Treasury market, and the largest PTFs had trading volumes that were roughly comparable to the volumes of the largest dealers. A Federal Reserve staff analysis found that PTFs were particularly active in the interdealer segment of the U.S. Treasury market in 2019, accounting for 61 percent of the volume on automated interdealer broker platforms and 48 percent of the interdealer broker volume overall.<sup>220</sup> Figure 1 also shows that non-FINRA member firms in the U.S. Treasury market (most of which we believe are not dealers) have a volume distribution that is comparable to the volume distribution of FINRA-members (most of whom are dealers). Based on PTFs' high trading volumes, and on the Federal Reserve staff finding that PTFs are particularly active in the interdealer segment of the U.S. Treasury market, we believe that PTFs have emerged as *de facto* liquidity providers in the U.S. Treasury market.

TABLE 1—COUNT OF ACTIVE FIRMS IN THE TREASURY MARKET BY TYPE: JULY 2021

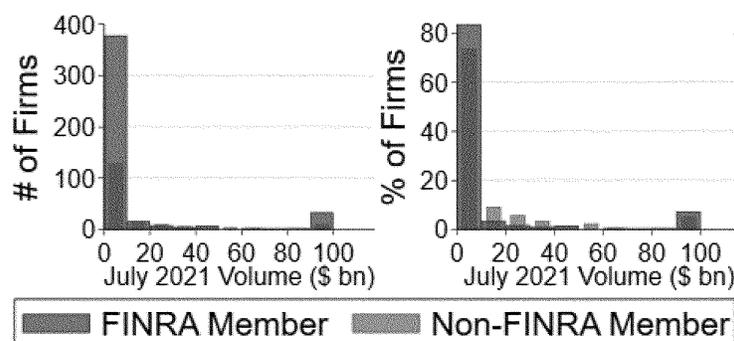
Firm type	# Firms with (buy + sell) volume >					
	\$0	\$1 bn	\$10 bn	\$25 bn	\$50 bn	\$100 bn
<i>FINRA-member firms</i> .....	452	126	74	53	38	32
Dealers .....	420	101	51	35	25	21
<i>Non-FINRA member firms</i> .....	174	95	46	23	14	9
Asset Managers .....	(†)	(*)	(*)	(*)	(*)	(*)
Dealers .....	80	42	20	(*)	(*)	(*)
Hedge Funds .....	41	17	(*)	(*)	(*)	(*)
Others .....	(†)	(*)	(*)	(*)	(*)	(*)
PTFs .....	38	30	22	18	13	9
Sum of *'s .....	15	6	4	5	1	0

† Suppressed; strictly greater than zero.

\* Suppressed; greater than or equal to zero.

**Figure 1. Treasury Trading Volume Distributions of FINRA Members and non-FINRA Members, July 2021**

This figure plots the number and percentage of identifiable firms in TRACE data for July 2021, by size category. The plots are truncated on the right by grouping together all firms with monthly volume of \$100 billion or greater.



Since the analysis behind Table 1 is limited to the subset of TRACE data where we can identify the individual firms,<sup>221</sup> the numbers of firms with trading volume above the various thresholds may be greater than shown in the table. This is also to say that, were the data to include all market participants, we would need higher thresholds to be able to report numbers of firms similar to what are shown in the table. We make this adjustment as follows. In July 2021, the analysis was able to determine the firm identity and FINRA membership status of 42 percent of the non-FINRA member volume; the remaining 58 percent of non-FINRA member volume was anonymous.<sup>222</sup> Under the assumption that all non-FINRA member market participants are

<sup>221</sup> See *supra* note 217.

<sup>222</sup> For each transaction, we consider each counterparty to be responsible for half of the volume. Therefore, for a transactions where we observe the identity of only one counterparty, we consider that we have only determined the firm identity and FINRA membership for half of the transaction's volume. We observe the identity of at least one counterparty for all transactions in TRACE, since trades between non-FINRA member firms are not reported to TRACE.

equally represented in both the anonymous and identified subsets of TRACE, the analysis equally undercounts the volume of all firms—*i.e.*, we assume that our analysis only contains 42 percent of identified non-FINRA member firms' volume. We acknowledge considerable uncertainty regarding this assumption. The assumption of equal representation in the observed and non-observed data suggests dividing the thresholds shown in Table 1 by 0.42 (or multiplying them by approximately 2.5). For example, Table 1 shows that our analysis counted 46 non-FINRA member firms with trading volumes of at least \$10 billion in July 2021; the adjustment would suggest that those 46 firms actually had trading volumes of above \$25 billion. However, firms in the various categories may not be equally represented in the identified and anonymous data. If, for example, PTFs are overrepresented in the identified data, then the actual number of PTFs with volumes over \$25 billion will be closer to 18 than to 22. We preliminarily estimate that approximately 46 non-FINRA member firms would surpass the \$25 billion

volume threshold given in the quantitative standard of the Proposed Rules. Although the analysis behind Table 1 only uses data from July 2021, we find that the number of firms that would have surpassed the \$25 billion volume threshold in four out of the last six calendar months remained relatively steady between 39 and 50 from September 2019 to July 2021, or the entire period for which data was available. Non-FINRA member counterparties are first identified in TRACE beginning in April 2019, so September 2019 is the first month in which we can count how many non-FINRA member firms would surpass the quantitative threshold in four out of the last six calendar months.

#### b. Private Funds

Private funds<sup>223</sup> are prominent participants in U.S. securities markets. As of the second quarter of 2021, the Commission observed the following

<sup>223</sup> See *supra* note 30.

types of private funds reported on Form PF:<sup>224</sup>

TABLE 2—PRIVATE FUND STATISTICS AS OF 2021Q2

Fund type	Count	Gross asset value		Net asset value	
		Total (\$B)	Avg (\$mm)	Total (\$B)	Avg (\$mm)
Hedge Fund .....	9,613	9,584	997	5,132	534
Private Equity Fund .....	15,861	4,825	304	4,270	269
Venture Capital Fund .....	1,424	222	156	214	150
Liquidity Fund .....	76	330	4,342	319	4,197
Other Private Fund .....	10,557	3,041	288	2,167	205

**Note:** These statistics rely on Form PF. Only SEC-registered advisers with at least \$150 million in private fund assets under management must report to the Commission on Form PF; SEC-registered investment advisers with less than \$150 million in private fund assets under management, SEC exempt reporting advisers, and state-registered investment advisers are not required to file Form PF.

Of the 9,613 hedge funds reported on Form PF, there were 1,968 qualifying hedge funds that reported information on their positions, and these held \$3.2 trillion in listed equities and \$1.7 trillion in U.S. Government securities. Of the 76 liquidity funds, 56 liquidity funds reported information on their positions, and these held \$94.8 billion in U.S. Government securities and \$21.7 billion in asset-backed securities.

Among private funds, hedge funds are the most likely to be engaged in activities that meet the Proposed Rules. As reported on Form PF, hedge funds and private equity funds are the largest by count and aggregate assets, and hedge funds and liquidity funds are the largest by average fund assets. However, the business models of private equity funds<sup>225</sup> and liquidity funds<sup>226</sup> are unlikely to fall under the Proposed Rules' qualitative factors, since they are generally long-only investors that are not likely to routinely make roughly comparable purchases and sales of the same or substantially similar securities in a day or to routinely quote markets to capture bid-ask spreads. As described above, "routinely" in the Proposed Rules means both repeatedly within a day (multiple times in a single day) and repeatedly over time (on the majority of days in a calendar month). Regarding the quantitative volume standard, liquidity funds may trade large volumes of U.S. Treasury securities, but the average reporting liquidity fund, as of the second quarter of 2021, held only \$1.7 billion of Treasury securities and

held the average positions for 40–50 days.<sup>227</sup> Such a fund is unlikely to regularly trade \$25 billion in U.S. Treasury securities in a month.

An important similarity between private funds and PTFs is the incentives involved for those making trading and investment decisions. PTFs, as the name implies, invest money for the principals, who then benefit directly from the trading gains. This is similar to many registered dealers. Similarly, private fund advisers, including their affiliates that operate as general partners of private funds, typically have a compensation arrangement by which they receive a significant portion of gains (often 20 percent). In both cases, these compensation arrangements may incentivize aggressive trading.

Certain hedge funds, on the other hand, may satisfy either the qualitative or the quantitative standards of the Proposed Rules, or both. The remainder of this section discusses whether current hedge fund activity may meet the standards, and describes regulations that currently apply to registered hedge fund advisers. The qualitative standards could potentially capture certain hedge fund trading strategies, such as those that may involve automated or high-frequency buying and selling of substantially similar securities in the same day. It is also possible that a large hedge fund could trade sufficient volumes of U.S. Treasury securities to satisfy the quantitative standard. The extent to which hedge funds may satisfy these standards is uncertain. Hedge

funds do not report their transactions, so they are not currently identifiable in CAT data or in TRACE data (beyond the subset of U.S. Treasury TRACE discussed previously).<sup>228</sup> Structured data are not available that would indicate how many hedge funds would satisfy the qualitative standards, but some hedge fund strategies would likely do so. We observe at least one hedge fund (number suppressed in Table 1 above) that surpassed the quantitative standard's threshold of \$25 billion in U.S. Treasuries in July 2021. Additional hedge funds may meet the quantitative threshold beyond those we observe—for instance, hedge funds who trade outside of covered ATs and so only appear in TRACE anonymously, or hedge funds that trade with other non-FINRA members (such as banks) and so do not appear in TRACE at all.

One hedge fund strategy that stands out is the Treasury basis trade,<sup>229</sup> as one study estimated that approximately 65 percent of hedge funds' total Treasury exposure was tied to the basis trade before March, 2020.<sup>230</sup> A hedge fund's basis trade is not likely to satisfy the qualitative standards of the Proposed Rules, because a futures contract and a Treasury of similar maturity would not qualify as substantially similar securities since the futures contract is not a security. Also, since transactions associated with repurchase agreements would not count toward the Proposed Rules' quantitative standard, most hedge funds' basis trading would likely not satisfy that standard. A large-volume

<sup>224</sup> See Division of Investment Management Analytics Office, SEC, Private Fund Statistics: Second Calendar Quarter 2021 (Jan. 14, 2022), available at <https://www.sec.gov/divisions/investment/private-funds-statistics/private-funds-statistics-2021-q2.pdf>

<sup>225</sup> See Investor.gov, Private Equity Funds, available at <https://www.investor.gov/introduction-investing/investing-basics/investment-products/private-investment-funds/private-equity>.

<sup>226</sup> See D. Hiltgen, "Private Liquidity Funds: Characteristics and Risk Indicators," DERA White Paper (Jan. 2017).

<sup>227</sup> See *supra* note 224, figures 18–19.

<sup>228</sup> See *supra* note 169. 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.

<sup>229</sup> In a long Treasury basis trade, participants take a long position in Treasury securities and a short position in Treasury futures, and then profit from the eventual convergence of cash and futures prices toward the delivery date. Hedge funds typically post the Treasury securities as collateral for repo funding.

<sup>230</sup> See Barth, Daniel, and R. Jay Kahn, "Hedge Funds and the Treasury Cash-Futures Disconnect," OFR Working Paper 21–01 (Apr. 1, 2021).

basis trading hedge fund could hypothetically be captured by the quantitative standard, but a recent study suggests that few, if any, basis trades involve enough Treasury trading volume to meet the threshold of \$25 billion per month in four out of the past six calendar months.<sup>231</sup> In 2019, when the basis trade was more attractive than at present, the study reported that the aggregate basis trade of the 44 largest participants held a long Treasury position of about \$400–\$500 billion (an average of only about \$9–\$11 billion per large basis trader). Furthermore, the basic strategy of the basis trade involves holding Treasury securities to the earlier of: (i) Maturity; or (ii) a time when the basis trade is no longer attractive.

As described above in Section III.A, the Commission is mindful that registered private fund advisers are currently regulated under the Advisers Act, and that advisers' requirements under the Advisers Act affect the activities of private funds. This regulatory regime includes anti-fraud measures applicable to all advisers and requires that many private fund advisers register with the Commission. The Advisers Act establishes reporting and recordkeeping requirements for registered advisers to private funds for investment protection and systemic risk purposes. Specifically, Section 204(a) of the Advisers Act requires registered investment advisers to keep certain books and records (records of the advised private funds are considered records of the adviser for these purposes), and Section 206 subjects registered investment advisers to several anti-fraud provisions, including antifraud liability with respect to current and prospective clients. Registered investment advisers also have fiduciary duties, which comprise a duty of care and a duty of loyalty.<sup>232</sup> Certain registered investment advisers must also submit annual and, for certain large advisers to certain large hedge funds, quarterly reports to the

Commission,<sup>233</sup> and they are subject to Commission examinations.

Differences between the regulatory regime that applies to registered advisers to private funds and the one that applies to securities dealers include leverage constraints, and reporting. Registered dealers' leverage is limited by net capital requirements, which must be maintained at all times, even intraday, while private funds have no formal leverage constraints. Private funds also do not report their securities transactions. Their fixed-income transactions do not appear in TRACE, or may appear anonymously as part of the reporting obligation of broker-dealers. Transactions in fixed-income securities other than municipal securities and U.S. Treasury securities are reported to TRACE and publicly disseminated (transactions in U.S. Treasury securities are reported to regulatory TRACE but not publicly disseminated), so markets have more post-trade transparency with regards to registered dealers than with regards to private funds. Private funds' transactions in national market system ("NMS") stocks, OTC equities, and listed options already appear in CAT, but some additional information is only available for firms that report directly to CAT. For example, currently, when a PTF sends orders to a broker-dealer, CAT will include the timestamp indicating when the order was received by the broker-dealer, but not the timestamps indicating when the order was originated or routed by the PTF. Additionally, if the PTF originates a larger order and splits it into smaller orders for routing to the broker-dealer, CAT will only include the smaller orders as they are received by the broker-dealer, but CAT will not include the larger order as originated. Regulators may be able to obtain more complete data on private funds' pre- and post-trade securities trading activity through examinations, but such information is more readily available for registered dealers.

<sup>233</sup> These reports are submitted through Form PF, which was adopted in 2011 as required by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. Pub. L. 111–203, 124 Stat. 1376 (2010). See Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF, Advisers Act Release No. 3308 (Oct. 31, 2011), 76 FR 71128 (Nov. 16, 2011) at section I.

### c. Number of Affected Parties

The precise number of affected parties is uncertain, since existing data does not provide a clear picture of all market participants' activities. For instance, we do not know how many PTFs routinely express trading interests that are at or near the best available prices on both sides of the market. Nevertheless, the discussion in this section seeks to provide some idea, based on available data, of the Proposed Rules' scope. First, we provide data on the number of entities that may satisfy the first qualitative factor by "routinely making roughly comparable purchases and sales of the same or substantially similar securities in a day." The analysis requires us to assume a particular functional form for this qualitative standard, but we do not mean to imply that the standard would be defined this way in practice. For the highest-volume U.S. Treasury security in July 2021 (the 10-year on-the-run note, with 15 percent of total U.S. Treasury volume), we compute a buy-sell volume imbalance for each firm and for each trading day as  $|B-S|/(B+S)$ , where B is the firm's daily buy volume and S is the firm's daily sell volume. A low buy-sell imbalance indicates purchases and sales in more similar dollar amounts. We then repeat the analysis for the highest-volume security in equity markets in October 2021 (the SPDR S&P 500 ETF, or "SPY", with 6.1 percent of the total volume of NMS stocks<sup>234</sup>).

For the U.S. Treasury market, Table 3 shows the number of non-FINRA member firms, by firm type, that had a "low" buy-sell volume imbalance—below 10 percent or, alternatively, below 20 percent—for at least 14 of the 21 trading days in July 2021. Twenty non-FINRA member firms had a buy-sell volume imbalance of less than 20 percent in at least 14 of 21 trading days and 15 non-FINRA member firms had a buy-sell volume imbalance of less than 10 percent in at least 14 of 21 trading days. All of these firms were PTFs.<sup>235</sup>

<sup>234</sup> For SPY volume, we use data from Intraday Indicators Aggregate Market Liquidity—WRDS. We rely on CBOE statistics for the total dollar volume of NMS stocks. See *U.S. Equities Market Volume Summary*, CBOE, available at [https://www.cboe.com/us/equities/market\\_share/](https://www.cboe.com/us/equities/market_share/).

<sup>235</sup> See *supra* note 218.

<sup>231</sup> See *id.*

<sup>232</sup> See Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Investment Advisers Act Release No. 5248 (June 5, 2019) 84 FR 33669 (July 12, 2019), at 24–25.

TABLE 3—COUNT OF NON-FINRA MEMBER FIRMS BY TYPE FOR THE TREASURY CUSIP WITH THE HIGHEST VOLUME IN JULY 2021

Total # firms	Firm type	# Firms with at least 14 of 21 days of buy-sell volume imbalance less than	
		10%	20%
Asset Manager .....	*	0	0
Dealer .....	74	0	0
Hedge Fund .....	29	0	0
Other .....	*	0	0
PTF .....	34	15	20
Sum of *s .....	6	0	0
<b>Total .....</b>	<b>143</b>	<b>15</b>	<b>20</b>

**Notes:** 1. Buy-sell volume imbalance =  $|B-S|/B+S$ , where B is firm’s daily buy volume and S is firm’s daily sell volume. 2. The Treasury CUSIP with the highest volume in July 2021 is for 10-year on-the-run Treasury note. In July 2021, the total volume for this CUSIP was about 15 percent of the total volume for all Treasury securities. 3. \* Suppressed; at least 1 firm of each type exists in the data (all suppressed numbers in the first column are greater than zero).

A comparison of these 15 or 20 firms with the list of 46 firms (see Table 1) that had total monthly Treasury-trading volume of more than \$10 billion<sup>236</sup> in July 2021 revealed considerable overlap between first qualitative standard and the qualitative standard: 17 of the 20 non-FINRA member PTFs with frequent buy-sell volume imbalance of less than 20 percent in Table 3 also had monthly volume greater than \$10 billion in Table 1; 14 of the 15 non-FINRA member PTFs with frequent buy-sell volume imbalance of less than 10 percent in Table 3 also had monthly volume greater than \$10 billion in Table 1.

The analysis for the equity market relied on CAT data. While PTFs and private funds do not directly report to CAT, their trades in NMS stocks, OTC equity securities, and listed options are reported to CAT by registered broker-dealers with whom they interact as customers (e.g., by trading through a registered broker-dealer or with a registered broker-dealer, including with an ATS). Specifically, for the original receipt or origination of an order, registered broker-dealers report to CAT the Firm Designated ID (“FDID”), which

is then assigned to various other CAT order events in the order lifecycle. These CAT FDIDs uniquely identify trading accounts of registered broker-dealers and can represent firm or customer accounts. Firm trading accounts include market-making accounts and other proprietary accounts of the registered broker-dealer. Customer accounts include mainly institutional customer accounts and individual customer accounts, but they also include customer average-price accounts and employee accounts where an employee of the registered broker-dealer is exercising discretion over multiple customer accounts.

Because the activity of all market participants is captured in CAT FDID customer accounts and because the Proposed Rules do not cover persons with total assets of less than \$50 million, in our analysis of SPY we focused on CAT FDID institutional customer accounts. Specifically, we computed buy-sell dollar volume imbalance for each CAT FDID institutional customer account and each trading day in October 2021. As in our analysis of Treasuries, we defined buy-

sell volume imbalance as  $|B-S|/(B+S)$ , where B is the firm’s daily buy volume and S is the firm’s daily sell volume. We also computed the total (i.e., buy plus sell) dollar volume in SPY for each CAT FDID institutional customer account and each trading day in October 2021.

Table 4 shows the number of CAT FDID institutional customer accounts that had both (i) a “low” buy-sell dollar volume imbalance in SPY and (ii) total buy plus sell dollar volume in SPY above a *de minimis* threshold, in at least 14 of 21 trading days in October 2021. We again define “low” to mean less than 10 percent or less than 20 percent. We include the *de minimis* threshold to remove small entities that are the most likely to be excluded from the Proposed Rules for having less than \$50 million in assets.<sup>237</sup> Table 4 shows results for two alternate *de minimis* thresholds: \$10,000 per day or \$100,000 per day. In addition to the number of CAT FDID institutional customer accounts that satisfied these criteria, Table 4 also shows the combined dollar volume of these accounts as percent of total SPY dollar volume in October 2021.

TABLE 4—NUMBER OF CAT FDID INSTITUTIONAL CUSTOMER ACCOUNTS WITH AT LEAST 14 OF 21 TRADING DAYS IN OCTOBER 2021 WITH THE SPECIFIED BUY-SELL DOLLAR VOLUME IMBALANCE AND BUY PLUS SELL DOLLAR VOLUME IN SPY

Buy-sell dollar volume imbalance less than .....	10%	20%	10%	20%
	AND			
Total buy plus sell dollar volume more than .....	\$10,000	\$10,000	\$100,000	\$100,000
# CAT FDID institutional customer accounts .....	44	61	41	57

<sup>236</sup> As discussed above, we believe that the \$10 billion threshold in our analysis, which is limited to the subsection of TRACE where we can verify traders’ identities, corresponds to the Proposed Rules’ quantitative threshold of \$25 billion.

<sup>237</sup> We did not discuss a *de minimis* threshold in the previous analysis for the U.S. Treasury market (see *supra* Table 3), because imposing a volume threshold even as high as \$1 million did not affect the count of firms that had low-imbalance and

above *de minimis* trading on each of 14 out of 21 days.

TABLE 4—NUMBER OF CAT FDID INSTITUTIONAL CUSTOMER ACCOUNTS WITH AT LEAST 14 OF 21 TRADING DAYS IN OCTOBER 2021 WITH THE SPECIFIED BUY-SELL DOLLAR VOLUME IMBALANCE AND BUY PLUS SELL DOLLAR VOLUME IN SPY—Continued

Combined dollar volume of these accounts as percent of total SPY dollar volume in October 2021 .....	3.3	6.3	3.3	6.3
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**Notes:** 1. Buy-sell volume imbalance =  $|B-S|/B+S$ , where B is firm's daily buy volume and S is firm's daily sell volume. 2. There were a total of 21,115 CAT FDID institutional customer accounts that traded SPY in October 2021. A CAT FDID "institutional customer account" is an institutional account as defined in FINRA rule 45121. See *supra* note [26] for further details.

The results in Table 4 indicate that between 41 and 61 CAT FDID institutional customer accounts (depending on the thresholds used) had both low buy-sell dollar volume imbalance in SPY and above *de minimis* total dollar volume in SPY in at least 14 of 21 trading days in October 2021, and the combined dollar volume of these accounts represented between 3.3 percent and 6.3 percent of total SPY dollar volume in October 2021. If the entities behind these accounts are not excluded or otherwise exempted, such trading activity could satisfy the qualitative standard of "routinely making roughly comparable purchases and sales of the same or substantially similar securities in a day."

The precise number of affected parties is highly uncertain, due to several shortcomings. The U.S. Treasury market analysis has the following caveats. First, we only analyze the buy-sell imbalance within a single CUSIP, though firms could potentially satisfy the standard based on other CUSIPs or on a combination of CUSIPs (the qualitative standard includes trading in either the "same" or "substantially similar" securities). Second, we do not observe the universe of U.S. Treasury trading. Third, this analysis imposes quantitative cutoffs in place of the qualitative standard, which is "roughly comparable purchases and sales." Due to the first two shortcomings, the actual number of parties affected by this qualitative standard may be higher than the 15 or 20 firms we estimate here. The third shortcoming introduces additional uncertainty, since we do not know whether the cutoffs assumed in the analysis—buy-sell imbalance less than 10 percent or 20 percent in at least 14 of 21 trading days—would align with the qualitative standard in all cases.

There are also caveats to the equity market analysis, as follows. First, there is currently no one-to-one correspondence between CAT FDID accounts and firms (although such information will be available starting in July 2022). Some market participants may have several CAT FDID institutional customer accounts, and some CAT FDID institutional customer accounts may represent more than one

customer. Therefore, the number of CAT FDID institutional customer accounts that satisfy various thresholds in Table 4 does not necessarily equal the number of market participants that would satisfy the qualitative standard of "routinely making roughly comparable purchases and sales of the same or substantially similar securities in a day." Furthermore, some of the CAT FDID institutional customer accounts that satisfy various thresholds in Table 4 may represent investments companies registered under the Investment Act, which are excluded from the Proposed Rules.

Despite these caveats, we believe that the results in Tables 3 and 4 provide useful indications about the scope of the Proposed Rules in the markets for U.S. Treasury securities and NMS stocks.

### 3. Externalities

When market participants who effectively provide liquidity do not comply with existing dealer regulations, including rules specifically designed to limit risk-taking and to deter manipulative or fraudulent behavior, the probability of behaviors that are financially risky, manipulative, or fraudulent increases. As described below, such behavior on the part of one firm may create negatively externalities on other firms. Although all liquidity providers are subject to Exchange Act Section 17(a), Section 10(b), and 17 CFR 240.10b-10 (Rule 10b-10 thereunder), liquidity providers that are not registered as dealers currently have more regulatory allowance to accept operational or financial risk. For example, net 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.<sup>238</sup> In contrast, the Net Capital Rule requires dealers to have highly liquid assets in excess of unsubordinated debt.<sup>239</sup> We are unable to estimate PTFs' leverage due to data limitations. PTFs and private funds also may not have the same obligations as dealers to implement operational risk controls.<sup>240</sup> In addition, PTFs are not subject to any examination or reporting requirements, and neither PTFs nor private funds are required to report securities transactions.

Even though all market participants face incentives to remain solvent and profitable, certain market participants may not bear all the costs of their failure. Therefore, they may not have sufficient incentive to ensure their ability to weather adverse shocks. When entities have leverage, for example, creditors may bear some of the costs of failure. As another example, entities that perform a significant share of liquidity provision may disrupt market trading if they fail, thus imposing costs on other entities.

These incentives, or lack of incentives, 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. 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. Instability in securities markets may appear when a failed liquidity provider exits the market or when a stressed liquidity provider temporarily reduces its

<sup>238</sup> Using data from "Private Fund Statistics" (*see supra* note 228), we estimate qualifying hedge funds' net capitalization as highly liquid assets minus secured debt. Dollar values of liquid assets are from Table 49 (portfolio liquidity for qualifying hedge funds as a percent of aggregate net asset value) and Table 4 (net asset value), and the value of secured debt is from Table 51 (borrowings of qualifying hedge funds).

<sup>239</sup> *See supra* notes 76 and 205.

<sup>240</sup> *See supra* note 206 and accompanying text.

activity, thereby reducing market liquidity for all traders until other liquidity providers can fill the gap. During the U.S. Treasury market volatility in March 2020, PTFs (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.”<sup>241</sup> 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).<sup>242</sup> 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. The associated volatility may heighten the inventory and operational risks of market participants throughout the securities markets. The failure of a large market participant can potentially propagate instability across securities markets if the failed entity actively trades many different asset classes simultaneously.

As discussed above, the Commission and the SROs have established rules designed to address the externalities related to financial stress, by promoting registered dealers’ financial responsibility and operational capability. Specifically, the rules seek to minimize the disruptions that can occur from losses related to operational risk. 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

<sup>241</sup> See 2021 IAWG Joint Staff Report at 13. Initially, PTFs increased trading activity, but they pulled back from market making several days later when volatility reached very high levels. (“In the first week of March, a large share of the increased trading volume came from PTFs, and on March 9, PTFs’ share of trading on electronic IDB platforms was just over 60 percent, a typical level. But as heavy net investor sales continued, the balance of activity in the interdealer market shifted . . . PTFs’ total share of activity fell to a low of 45 percent on March 16. Dealers’ total volumes on electronic IDB platforms also declined, but less sharply than PTFs’ volumes.”)

<sup>242</sup> See Brogaard, Jonathan, Allen Carrion, Thibaut Moyaert, Ryan Riordan, Andriy Shkilko, Konstantin Sokolov, 2018, High Frequency Trading and Extreme Price Movements, *Journal of Financial Economics* 128(2), 253–265.

be rapidly liquidated at a loss.<sup>243</sup> 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. However, these regulations do not currently apply to market participants that are not registered as dealers. We do not have sufficient oversight to understand what risk-management controls PTFs may have in place, how much leverage they use, or how liquid their assets are. Private funds’ risk-taking may be constrained by their advisers’ fiduciary duties, but, as described above, we believe that the average hedge fund is more leveraged than the Net Capital Rule would allow (although we acknowledge the uncertainty around our estimate).

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. 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<sup>244</sup> or CAT<sup>245</sup>), 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 manner across all dealers. PTFs do not

<sup>243</sup> 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).

<sup>244</sup> 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.

<sup>245</sup> As discussed above, 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.

submit financial reports to regulators or report their transactions, and have no regulatory books and records guidelines. Private funds also do not report transactions to TRACE or directly to CAT, but registered private fund advisers are subject to regular reporting requirements<sup>246</sup> and to books and records rules. In addition, the Commission has examination authority with respect to registered private fund advisers.

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. For regulators, the gap between what information registered dealers report and what information other market participants report varies by type of participant, but may include annual or quarterly reporting, and transactions reports. For investors, the gap consists of transactions reports for fixed-income securities other than U.S. Treasury and municipal securities, which reports are made publicly available. As discussed previously, large private fund advisers file regular reports to the Commission on Form PF, and the Commission also has authority to examine private fund advisers. However, private funds do not report their securities transactions to TRACE. Private funds’ fixed-income transactions may appear in TRACE with the private fund identified, if the trade occurs on certain ATSs; the transactions may appear in TRACE with the private fund anonymous, if the trade occurs outside certain ATSs but with another FINRA member firm; or the transactions may not appear in TRACE at all if the private fund trades with a non-FINRA member firm. PTFs do submit financial reports to regulators, do not report transactions, and are not subject to examinations, so regulators have very little insight into their activities. Private funds also do not report their securities transactions directly to CAT. As discussed previously, their trades in NMS stocks, OTC equities, and listed options are indirectly reported to CAT by other counterparties, but CAT does not contain certain other information on firms who do not report directly.

Information limitations in the market for U.S. Treasury securities became especially apparent during the instability of March 2020. The IAWG noted in its 2021 IAWG Joint Staff Report on November 8, 2021, that “In March 2020 . . . there was a [particular]

<sup>246</sup> See *supra* note 233 and accompanying text.

need for timely information on the positions and transactions of institutions other than dealers.”<sup>247</sup> Wider TRACE reporting would have provided more of such information. Similar information limitations exist in the markets for other fixed-income securities. Unregistered market participants’ transactions in NMS stocks, OTC equities, and listed options are reported to CAT by other (registered) parties, but their identities in the data remain anonymous and some pre-trade data are not reported at all—e.g., time stamps and indications that a large order has been broken into several smaller orders. Investors who rely on publicly disseminated TRACE also are impacted by the unreported or the anonymity of important market participants’ trading activities.

4. Competition Among Liquidity Providers

An analysis of the cash U.S. Treasury market for July 2021<sup>248</sup> finds that liquidity provision in the market is reasonably competitive.<sup>249</sup> Table 5 below categorizes firms as potential liquidity providers in three ways and displays two measures of market

concentration. In column 1, potential liquidity providers include only dealers. In column 2, the list of liquidity providers also includes PTFs. In column 3, the list of liquidity providers further includes hedge funds.<sup>250</sup> The first measure of concentration displayed in each column is the volume share of the 5 highest-volume firms. The second concentration measure is the Herfindahl-Hirschman index (HHI), which is equal to the sum of squared market shares. An index of 1 would indicate a completely concentrated market with a single liquidity provider. The inverse of the HHI provides some intuition by giving the number of equally sized competitors that would lead to such a HHI. For example, a market with 5 equally sized competitors would have a HHI of 1/5 or 0.2. The first column of Table 5 shows that 500 dealers were active in the U.S. Treasury market in July, 2021, and that the 5 highest-volume of these accounted for 43 percent of the group’s total volume. The HHI of liquidity provision in this column is 0.054, or comparable to the competitive environment that would exist if there were 18 equally sized liquidity providers. If we also consider

PTFs (limited to the PTFs that we can identify in TRACE) to be liquidity providers (column 2), then 545 liquidity providers were active in July 2021 and the 5 highest-volume firms accounted for 34 percent of the group’s total. The HHI in this case is 0.04, which is comparable to the competitive environment that would exist among 25 equally sized firms. If we further consider hedge funds (again, limited to the hedge funds that we can identify in TRACE) to be liquidity providers (column 3), then 586 liquidity providers were active in the U.S. Treasury market in July, 2021, and the 5 highest-volume firms accounted for one-third of the group’s total volume. In this third column, the HHI is 0.039, which is comparable to the competitive environment that would exist among 26 equally sized firms. The minimal difference between the numbers in row 2, columns 2–3, does not suggest that hedge funds do not provide significant liquidity in the U.S. Treasury market. The minimal difference only means that the hedge funds that we can identify in TRACE do not appear to provide significant liquidity in the U.S. Treasury market.

TABLE 5—COMPETITION AMONG LIQUIDITY PROVIDERS IN THE TREASURY MARKET, JULY 2021

[The largest 5 firms in this table overall are dealers]

	Liquidity providers: dealers	Liquidity providers: dealers + PTFs	Liquidity providers: dealers + PTFs + hedge funds
No. of liquidity providers .....	500	545	586
Share of entire TRACE Sample .....	52.1%	68.7%	69.4%
Top-5 volume share (within group) .....	42.6%	33.6%	33.3%
HHI .....	0.054	0.040	0.039
comparable to N equal-size competitors .....	18	25	26

The Commission also understands that a large number of firms provide liquidity provision in the markets for corporate bonds and for equities (not necessarily the same firms), and that intermediation activity is reasonably competitive in both markets. Research has documented that, as of the first quarter of 2020, about 600 dealers intermediated in the market for corporate bonds, but that the top 10 dealers controlled approximately 70 percent of the volume.<sup>251</sup> Another analysis by the Commission<sup>252</sup> found

that of the 3,972 broker-dealers that filed Form X-17a-5 (FOCUS report) in 2016, 430 of them were also members of U.S. equities exchanges, and that the largest 20 broker-dealers controlled approximately 75 percent of the total assets of all broker-dealers.

The current competitive landscape among liquidity providers is also shaped by the difference in regulatory treatment between registered dealers and unregistered market participants that the Commission believes perform dealer-like roles in the markets. The

additional requirements to which registered dealers are subject may result in higher compliance for registered dealers, which could incentivize less-regulated firms such as PTFs to gain market share, or to continue to gain market share, from more-regulated dealers. These dynamics may especially apply to the electronic interdealer segment of the Treasury market, where PTFs now account for a majority of trading activity (as of 2019).<sup>253</sup>

<sup>247</sup> See *supra* note 5.

<sup>248</sup> See *supra* notes 217, 218, and 219, and accompanying text.

<sup>249</sup> A Federal Reserve analysis from 2020 finds that activity on electronic interdealer platforms is slightly more concentrated, with an HHI of 0.082. See *supra* note 2.

<sup>250</sup> Firms are classified based on an understanding of the individual firms’ businesses. See *supra* note 218.

<sup>251</sup> O’Hara, Maureen, and Alex Zhou, Anatomy of a Liquidity Crisis: Corporate Bonds in the Covid-19 Liquidity Crisis, May 2020, working paper.

<sup>252</sup> Transaction Fee Pilot for NMS Stocks, Exchange Act Release No. 82873 (Mar. 14, 2018), 83 FR 13008 (Mar. 26, 2018).

<sup>253</sup> See *supra* note 2.

*C. Economic Effects, Including Impact on Efficiency, Competition, and Capital Formation*

As described above in Section II, the Commission believes that the Proposed Rules would support the stability and transparency of U.S. Treasury and other securities markets by closing the regulatory gap that currently exists and ensuring consistent regulatory oversight of persons engaging in the type of activities described in the Proposed Rules. As described in Section II, the Commission believes that the Proposed Rules would support the stability and transparency of U.S. Treasury and other securities markets by closing the regulatory gap that currently exists and ensuring consistent regulatory oversight of persons engaging in the type of activities described in the Proposed Rules. Specifically, the rules would result in increasing the share of liquidity provision undertaken by persons who are subject to dealer rules related to financial risk-taking, reporting, deceptive practices, and examinations. As discussed above, these benefits would all be associated with PTFs registering as dealers, but private funds' potential dealer registration would also bring benefits related to net capital requirements and transaction reporting. If registered private fund advisers were to register as dealers, the benefits of transaction reporting would apply, but the marginal benefits of other reporting requirements, net capital requirements, books and records rules, and examinations might be very small, since the regulatory regime that applies to registered private fund advisers already contains similar provisions to the rules that apply to dealers.

Costs of the Proposed Rules include registration and membership fees, costs of record-keeping and reporting, and costs associated with net capital requirements. Additionally, the Proposed Rules may influence patterns of market participation, which may in turn affect competition among liquidity providers, market efficiency, and capital formation.

### 1. Benefits

The Proposed Rules seek to mitigate the externalities, discussed in the baseline, that may arise when market participants who effectively provide liquidity experience financial stress, engage in manipulative or fraudulent behavior, or whose operations are not subject to regulatory oversight. To the extent that unregistered market participants engage in activities that satisfy the qualitative or quantitative standards of the Proposed Rules,

requiring them to register as dealers would promote stability in U.S. securities markets and would help protect investors. Specifically, the Proposed Rules would bring liquidity providers that are not registered as dealers into compliance with dealer regulations related to financial risk-taking, reporting, and examinations. As previously discussed, we believe that PTFs would be the most affected parties, though potentially some private funds may be affected. Registered private fund advisers may also be affected under limited circumstances.

*Regulations on Financial Risk-Taking:* Registered dealers are subject to net capital requirements (Exchange Act Rule 15c3-1) and to various risk management rules that promote operational integrity.<sup>254</sup> Unregistered PTFs and private funds do not have net capital requirements, and they may not have the same risk-management requirements. The Net Capital Rule requires dealers to maintain sufficient liquid resources to meet all liabilities at all times,<sup>255</sup> thus limiting their probability of financial failure by constraining leverage and creating incentives against excessive risk-taking,<sup>256</sup> and also helping protect creditors. These provisions help reduce the externalities related to defaults and disorderly trading, which may arise due to firms' financial stress. As discussed in Section III, the Proposed Rules would require registration of persons whose trading activity contributes significantly to market liquidity or to price discovery. Such persons have the ability to significantly impact the markets, so placing these regulatory safeguards around their risk-taking would benefit investors and support capital formation by promoting stable markets. These benefits would be largest for PTFs and private funds, who are currently under no regulations related to risk-taking, but they could also apply to registered private fund advisers.<sup>257</sup>

<sup>254</sup> See *supra* notes 205 and 206 and accompanying text.

<sup>255</sup> See *supra* note 76.

<sup>256</sup> See also Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital and Segregation Requirements for Broker-Dealers, Exchange Act Release No. 86175 (June 21, 2019), 84 FR 43872 (Aug. 22, 2019).

<sup>257</sup> Registered private fund advisers are currently regulated in their capacity as advisers, and the current adviser regulation contains provisions related to financial risk-taking. However, the Proposed Rules could also apply to advisers that trade with their own proprietary capital. The adviser's proprietary trading is not currently regulated, so the benefits of registering such an adviser would be comparable to the full benefit of registering a PTF.

*Regulations on Reporting:* Registered dealers must file annual reports with the Commission that include audited financial statements.<sup>258</sup> They also report their transactions of NMS stocks, OTC equities, and listed options directly to CAT,<sup>259</sup> and registered dealers who have selected FINRA as their SRO report their transactions in fixed-income securities (other than municipal securities) to TRACE.<sup>260</sup> Unregistered PTFs do not report any of this information to regulators. Private fund advisers report certain information on the private funds they manage to the Commission annually (and, for certain large advisers of certain large hedge funds, each quarter), but they do not report transactions.

Reporting requirements, particularly requirements to report transactions directly, enable regulators to conduct market research that informs their efforts to detect or respond to market events, to inform investors, to ensure that dealers' activities are in compliance with regulation, and research has also shown that transaction reporting can improve market efficiency and liquidity.<sup>261</sup> Transaction reporting in general enhances the ability of the Commission and SROs to more efficiently and in a more timely manner monitor trading, which should further enhance the ability of the Commission and SRO staff to effectively enforce SRO rules and the Federal securities laws, rules, and regulations.<sup>262</sup> This enhanced ability of the Commission and SROs staff to enforce the Federal securities laws, rules, and regulations should help ensure the efficiency and stability of the markets, and promote investor confidence in the fairness of the securities markets, which may in turn promote capital formation.<sup>263</sup> TRACE for fixed-income securities other than municipal securities and U.S. Treasury

<sup>258</sup> See *supra* note 77.

<sup>259</sup> Unregistered market participants' transactions in NMS stocks, OTC equities, and listed options are reported to CAT by other (registered) parties, but, as described above, certain information is only available for entities that report directly to CAT.

<sup>260</sup> Unregistered market participants' transactions in U.S. Treasury securities may appear in TRACE under certain conditions, but they usually appear with the unregistered counterparty's identity kept anonymous. See *supra* note 217.

<sup>261</sup> See Bessembinder, Hendrik, William Maxwell, and Kumar Venkataraman, 2006, "Market Transparency, Liquidity Externalities, and Institutional Trading Costs in Corporate Bonds," *Journal of Financial Economics* 82(2), 251-288; and Edwards, Amy K., Lawrence E. Harris, and Michael S. Piwowar, 2007, "Corporate Bond Market Transaction Costs and Transparency," *The Journal of Finance* 62(3), 1421-1451.

<sup>262</sup> See Consolidated Audit Trail, Exchange Act Release No. 62174 (May 26, 2010), 75 FR 32556 (June 8, 2010).

<sup>263</sup> *Id.*

securities are made publicly available to investors, so this transaction reporting to non-regulatory TRACE particularly informs investors. The absence of reporting requirements for consequential market participants thus creates negative externalities for investors. The Proposed Rules are designed to target persons whose activities can significantly impact markets or who otherwise trade large volumes of U.S. Treasuries Securities; requiring such persons to further inform regulators of their activities further promotes market stability, investor protection, and capital formation. To the extent that registered dealers were to select an SRO other than FINRA, the benefits related to fixed-income transaction reporting would not appear.<sup>264</sup>

**Regulations on Deceptive Practices:** Registered dealers are subject to the anti-manipulation and antifraud provisions of Sections 10(b) and 17(a) of the Exchange Act, but they are also subject to the specific anti-manipulative and other anti-fraud rules promulgated under Section 15(c) of the Exchange Act.<sup>265</sup> Neither unregistered PTFs nor private funds are subject to Section 15(c)(1) and related rules, but registered private fund advisers are subject to antifraud provisions under Section 206 of the Advisers Act. The persons whom the Proposed Rules would require to register would be those with the ability to significantly impact markets, including by manipulation or fraud. Therefore, subjecting them (particularly the PTFs) to the anti-fraud rules that apply to registered dealers, would contribute to fair and orderly markets and to investor protection.

**Regulations related to Examinations:** Registered dealers are subject to examinations by the Commission and by the relevant SRO, and they are also required to comply with certain books and records requirements.<sup>266</sup> PTFs that are not registered as dealers are not subject to examinations or to books and records rules, but the Commission has examination authority with respect to private fund advisers, and registered private fund advisers are subject to recordkeeping requirements. Examinations help regulators detect manipulative or fraudulent activities, as well as verify more generally that persons are in compliance with all relevant regulations. Books and records requirements facilitate examinations by ensuring that data entries are defined, recorded, and preserved in a consistent

manner across all dealers. The Proposed Rules would allow regulators to examine firms that currently are not registered, including PTFs, who are not currently subject to examinations, but whose activity contributes significantly to market liquidity or to price discovery. Therefore, since examinations help ensure compliance with other rules, this benefit of the Proposed Rules supports all the other benefits discussed above.

Some entities who would satisfy the Proposed Rules' qualitative or quantitative standards might nevertheless avoid the registration requirement by exiting a liquidity-providing strategy. If unregistered entities were to exit and bid-ask spreads were to meaningfully widen, other (registered) dealers might step in to replace the lost activity. This scenario would result in an effective transfer of dealer activity from unregistered market participants to registered dealers, and so would preserve the benefits (and costs) of the Proposed Rules.

## 2. Costs Associated With Becoming a Registered Dealer

The Proposed Rules would impose costs on certain market participants, including costs of registering with the Commission and with an SRO, recordkeeping and reporting costs, direct costs that may stem from meeting net capital requirements (*i.e.*, continuously monitoring capitalization), and self-evaluation as to whether one is a dealer or not.<sup>267</sup>

The initial registration costs would include the costs associated with filing Form BD and Form ID, SRO membership application fees, and any related legal or consulting costs that may be needed to (*e.g.*, ensure compliance with rules), including drafting policies and procedures as may be required. The ongoing costs would include the costs associated with amending Form BD, ongoing fees associated with SRO membership, and any legal work relating to SRO membership.

The Commission estimates compliance costs of approximately \$600,000 initially and \$265,000 annually thereafter to register as a broker-dealer with the Commission, become a member of an SRO, and comply with the associated dealer regulations.<sup>268</sup> The costs include

<sup>267</sup> Registered dealers would be subject to requirements, such as Exchange Act Rule 15c3-1 and 17 CFR 240.17a-1, 240.17a-3, 240.17a-4, and 240.17a-5 (Exchange Act Rules 17a-1, 17a-3, 17a-4, and 17a-5).

<sup>268</sup> Exchange Act Release No. 76324 (Oct. 30, 2015), 80 FR 71388, 71509 (Nov. 16, 2015) ("Regulation Crowdfunding Adopting Release")

personnel hours, outside legal services, building and maintaining books and records systems, obtaining or maintaining employee licensure, and direct costs associated with calculating net capital to comply with the Net Capital Rule. The compliance costs associated with net capital, reporting, and recordkeeping requirements would depend on the business structure of a registered dealer (*i.e.*, the capital structure of a dealer and the scope of a dealer's activities).<sup>269</sup> For example, these costs may be lower for private funds, since their advisers are already subject to requirements concerning books and records, examinations, and internal control systems. In general, the costs would also vary significantly depending on the types of securities a broker-dealer holds, the level of net capital a broker-dealer maintains, and whether a broker-dealer carries customer accounts, carries for other broker-dealers, is a registered investment adviser, is affiliated with an investment adviser, or transacts in a principal capacity.<sup>270</sup>

For dealers that select an SRO other than FINRA (*i.e.*, an exchange), we believe that the initial and ongoing costs would be less than \$600,000 initially and less than \$265,000 annually thereafter. Dealers that select FINRA as their SRO would incur the costs of reporting their fixed-income transactions (other than municipal securities) to TRACE.<sup>271</sup> Dealers that

estimates the costs of registering as a dealer, becoming a member of a national securities association, and complying with the associated regulation would be approximately \$520,000 initially and \$230,000 annually thereafter. Most of these costs involve personnel hours and legal services (currently, the direct costs of FINRA registration range between \$7,500 and \$60,000). Since the cost of legal services and nominal wages paid to administrative and financial operations employees have approximately risen with the consumer price index since 2015, we adjust these estimates for inflation of 15.33 percent between October 2015 and September 2021, based on the Consumer Price Index for All Urban Consumers (CPI-U) as recorded by the Bureau of Labor Statistics. See *Consumer Price Index*, U.S. Bureau of Labor Statistics, available at <https://www.bls.gov/cpi/data.htm>. We therefore estimate the costs to be approximately \$600,000 initially and \$265,000 annually thereafter. We recognize that these costs may vary significantly across registrants, depending on facts and circumstances.

<sup>269</sup> 2022 ATS Proposing Release at 15629.

<sup>270</sup> *Id.*

<sup>271</sup> TRACE fees include system fees of between \$20 and \$260 per month plus transaction reporting fees, which are one of: (i) \$0.475 per trade for trades with par value up to \$200,000, (ii) \$2.375 per million dollars par value for trades with par value more than \$200,000 but less than \$1 million, or (iii) \$2.375 per trade for trades with par value of at least \$1 million or \$1.50 per trade for agency pass-through MBS that are traded TBA or SBA-backed ABS that are traded TBA. See FINRA Rule 7730

<sup>264</sup> See *supra* note 77.

<sup>265</sup> See *supra* note 80.

<sup>266</sup> See *supra* note 79.

trade NMS stocks, OTC equities, or listed options would incur the costs of reporting their transactions in these securities to CAT.<sup>272</sup> As discussed in the CAT Notice and in the CAT Approval Order, the costs of CAT reporting may vary significantly across broker-dealer firms depending on the size and scope of their activities (e.g., the number of CAT-reportable order events that the firm has and whether the firm needs to report customer information).<sup>273</sup> In these releases, the Commission estimated that the one-time implementation costs related to CAT reporting could range from \$849,000 for small firms that did not previously report to the Order Audit Trail System (OATS) to \$7,231,000 for many large firms.<sup>274</sup> The Commission also estimated that the ongoing annual costs of CAT reporting could range from \$443,000 for small firms to \$4,756,000 for many large firms.<sup>275</sup> We adopt these estimates and adjust them for inflation between November 2016 and September 2021.<sup>276</sup> This adjustment yields a per-firm cost estimate of approximately \$965,000 to \$8,218,000 for one-time implementation plus ongoing costs of approximately \$503,000 to \$5,405,000 annually.

The wide range of these estimates indicates significant uncertainty about the costs related to CAT reporting that individual firms that trade equities or options may have to incur if they are required to register as dealers as a result of the Proposed Rules. We make two related observations. First, firms that would start reporting to CAT as a result of the Proposed Rules are likely to have

(Trade Reporting and Compliance Engine), available at <https://www.finra.org/rules-guidance/rulebooks/finra-rules/7730>.

<sup>272</sup> See Joint Industry Plan; Order Approving the National Market System Plan Governing the Consolidated Audit Trail, Exchange Act Release No. 79318 (Nov. 15, 2016), 81 FR 84696 (Nov. 23, 2016) (“CAT Approval Order”). See also See Joint Industry Plan; Notice of Filing of a National Market System Plan Regarding Consolidated Equity Market Data, Exchange Act Release No. 77724 (Apr. 27, 2016), 81 FR 30614 (May 17, 2016) (“CAT Notice”).

<sup>273</sup> See CAT Notice, 81 FR 30712–30726 and CAT Approval Order, 81 FR 84857–84862.

<sup>274</sup> See CAT Notice, 81 FR 30725–30726 and CAT Approval Order, 81 FR 84861–84862. The Commission also estimated that small firms that previously reported to OATS would incur lower one-time implementation costs related to CAT reporting—\$424,000. However, we believe that this lower estimate for related implementation costs is not applicable to firms that would be covered by the Proposed Rules, because firms that would be required to register as dealers and start reporting to CAT as a result of the Proposed Rules are unlikely to have prior experience of reporting to OATS.

<sup>275</sup> See *id.*

<sup>276</sup> The estimates are adjusted for an inflation rate of 13.66 percent based on the Bureau of Labor Statistics data on CPI-U between November 2016 and September 2021. See *supra* note 268.

a relatively large number of CAT-reportable order events, since the Proposed Rules are targeting significant liquidity-providers. Therefore, for these firms, the costs of CAT reporting are likely to be higher than the lower bounds of \$965,000 for implementation costs and \$503,000 for ongoing annual costs.<sup>277</sup> Second, firms that would be required to report to CAT as a result of the Proposed Rules do not carry customer accounts and would therefore not need to report any customer information to CAT. Thus, for these firms, the costs of CAT reporting are likely to be lower than the upper bounds of \$8,218,000 for implementation costs and \$5,405,000 for ongoing annual costs.<sup>278</sup>

The Commission recognizes that the costs associated with obtaining and maintaining SRO membership and reporting transactions may vary significantly depending on entity characteristics, activity characteristics, and the degree of the firm’s reliance on outside legal or consulting advice. For example, the costs of FINRA membership<sup>279</sup> depend on, among other things, the number of associated persons being registered, the scope of brokerage activities, revenue,<sup>280</sup> the number of

<sup>277</sup> It is also possible that a firm would satisfy the quantitative or the qualitative standards of the Proposed Rules by transacting in asset other than those that are reported to CAT. Such a firm would still be required to register as a dealer and report any transactions it may have in NMS stocks, OTC equities, and listed options. However, such a firm could have a relatively low number of CAT-reportable order events and hence relatively low costs of CAT reporting.

<sup>278</sup> In the CAT Approval Order, the Commission discussed its belief that the requirement of the CAT NMS Plan to report customer information represents a significant source of CAT reporting costs. See CAT Approval Order, 81 FR 84868–84869. Furthermore, in the CAT Notice, the Commission estimated CAT reporting costs for 14 electronic liquidity providers (“ELPs”), which are large registered broker-dealers that do not carry customer accounts and are not FINRA members. See CAT Notice, 81 FR 30724–30726. The Commission estimated that for these ELPs the one-time implementation costs related to CAT reporting would be \$3,876,000 and the annual ongoing costs of CAT reporting would be \$3,226,000. When adjusted to inflation between November 2016 and September 2021 (see *supra* note 265), these estimates become approximately \$4,405,000 for the one-time implementation costs and approximately \$3,667,000 for the annual ongoing costs of CAT reporting. Because the ELPs do not carry customer accounts and operate as liquidity providers in the markets for equities and options, their estimated costs of CAT reporting may be applicable to some of the larger firms that would be required to report to CAT as a result of the Proposed Rules.

<sup>279</sup> See *Schedule of Registration and Exam Fees*, FINRA, available at <https://www.finra.org/registration-exams-ce/classic-crd/fee-schedule#examfees>, for the schedule of FINRA registration fees.

<sup>280</sup> FINRA imposes a Gross Income Assessment as follows: (1) \$1,200 on a Member Firm’s annual gross revenue up to \$1 million; (2) a charge of

registered persons, the number of branch offices, and trading volume. TRACE and CAT reporting costs also vary depending on security type, order size, and trading venue, among other factors. Entities with a smaller number of registered persons, fewer brokerage activities, smaller trading volume, and smaller revenue would face lower direct costs.

In addition to the monitoring costs incurred to comply with the Net Capital Rule, described above, newly registered dealers who previously held less capital than what is required would have to increase their capitalization either by raising equity or by scaling back trading activities. However, since higher levels of net capital reduce a firm’s probability of default, these direct costs of net capital requirements may be partially offset by reductions in the firm’s cost of capital.

Market participants may also incur costs related to self-evaluation regarding whether the qualitative standards describe their activities. Since the quantitative standard is based on monthly Treasury-trading volume, which is easy to define and measure, we do not believe any market participants would incur additional costs to assess whether this standard would require them to register.

Some currently unregistered market participants may be affiliated with other firms that are currently registered dealers, and in such cases, the unregistered firm may seek to avoid the direct costs described above by shifting trading volume to its affiliated dealer. Other entities that are captured by the Proposed Rules may restructure their legal organization to isolate the activity that triggered the rules into a separate entity. Such activity shifting and legal reorganizations may incur costs, such as the costs of changing computer systems or paying attorney fees. To the extent that the securities-dealing activity ends

0.1215 percent on a Member Firm’s annual gross revenue between \$1 million and \$25 million; (3) a charge of 0.2599 percent on a Member Firm’s annual gross revenue between \$25 million and \$50 million; (4) a charge of 0.0518 percent on a Member Firm’s annual gross revenue between \$50 million and \$100 million; (5) a charge of 0.0365 percent on a Member Firm’s annual gross revenue between \$100 million and \$5 billion; (6) a charge of 0.0397 percent on a Member Firm’s annual gross revenue between \$5 and \$25 billion; and (7) a charge of 0.0855 percent on a Member Firm’s annual gross revenue greater than \$25 billion. When a firm’s annual gross revenue exceeds \$25 million, the maximum of the current year’s revenue and average of the last three years’ revenue is used as the basis for the income assessment. See also *Regulatory Notice 09–68: SEC Approves Changes to the Personnel Assessment and Gross Income Assessment Fees*, FINRA (effective Jan. 1, 2010), available at <https://www.finra.org/rules-guidance/notices/09-68>.

up being conducted by an entity that registers with the Commission, all the benefits of Proposed Rules still apply.

In response to a related initiative in 2010,<sup>281</sup> at least one PTF expressed its opinion to the Commission that the costs of PTF registration are not justified because equity markets worked well during the autumn of 2008 (then the most-recent financial crisis) and because the PTF believed that PTFs in general help market integrity by providing liquidity during difficult situations.<sup>282</sup> However, the 2021 IAWG Joint Staff Report showed that, during the U.S. Treasury market volatility of March 2021, PTFs' share of market intermediation fell considerably more than did dealers' share.<sup>283</sup> These results suggest that PTFs may not, or may no longer, promote market stability in all securities markets in ways that registered dealers do not. Accordingly, we believe that the benefits of registering PTFs who are also significant market participants justify the costs.

PTFs, since they do not have clients or customers, would bear the costs of registration themselves. Private funds, however, may either bear the costs themselves or the costs may be borne by their investment adviser. If the funds bear the costs, these costs would be passed on to the funds' investors.

### 3. Other Effects, Including Impact on Efficiency, Competition, and Capital Formation

The Proposed Rules may produce several indirect benefits or costs, based on the extent to which they encourage or discourage participation in securities markets. The Proposed Rules could either increase or decrease market participation due to three possible effects. First, fairer and more stable markets could encourage greater market participation. Second, registration and compliance costs could lead some currently unregistered liquidity providers to decrease their activity or even exit the market. If they do so, other firms may or may not increase their own activity to compensate. Third, large-volume and small-volume market participants may choose to differentially increase or decrease their market participation, so that the Proposed Rules may affect market concentration. Changes in patterns of market participation could affect market

efficiency, market competition, and capital formation.

#### a. Effects on Efficiency

The Proposed Rules could affect market efficiency—*i.e.*, price discovery, or the speed with which new information or developments impact the market price of a security—depending on whether the net effect on market participation is positive or negative. Other things equal, markets with greater participation are more liquid. The net effect on market efficiency is uncertain. On the one hand, improved investor confidence might lead to greater market participation that improves market efficiency for two reasons. First, new market participants may have additional information, in which case the orders they submit based on this information would aid price discovery. Second, higher trading volumes would mean that prices would react faster to changes in securities' fundamental values.

On the other hand, if important and informed market participants, such as PTFs or hedge funds, permanently reduce their market activity or their pursuit of certain investment strategies, market efficiency may decline in the markets for some securities.

#### b. Effects on Competition

The net effect that the Proposed Rules may have on competition is uncertain. On the one hand, the Proposed Rules would promote competition by standardizing the regulatory treatment of—*i.e.*, leveling the playing field for—all firms engaged in the activities that meet the proposed standards described above.<sup>284</sup> For instance, the Proposed Rules would require all firms that conduct these activities to incur the costs of complying with the same rules regarding registration, net capital requirements, books and records, and other requirements; whereas currently, only those who are registered bear these costs.

On the other hand, other effects on competition among liquidity providers<sup>285</sup> depend on the extent to which the rules encourage or discourage market participation by affected parties. The indirect benefits to all market participants—particularly the additional risk-mitigating provisions and the Commission's increased ability to detect

manipulation or fraud—may encourage some market participants to increase their liquidity-providing activities. However, the direct costs that the Proposed Rules would impose on currently unregistered firms who currently engage in covered activities may cause them to scale back these activities.<sup>286</sup> For example, if a hedge fund strategy were to fall under the Proposed Rules, the fund engaged in that activity might exit the strategy altogether in order to avoid registration. Some research on high-frequency trading has shown that firms engaged in this activity improve competition across trading venues, by arbitraging cross-venue differences in security prices,<sup>287</sup> which suggests that their withdrawal may have a negative impact on competition. Furthermore, in response to a similar initiative in 2010, commenters stated that registering PTFs as dealers would negatively impact competition among liquidity providers by creating barriers to entry.<sup>288</sup>

Any net effect on competition would likely be small because, as discussed in the baseline for competition above (including Table 5 for the U.S. Treasury market), we understand that liquidity provision in securities markets is reasonably competitive even among currently registered dealers. The precise magnitude of the effect in competition is also uncertain, and would depend on whether the benefits would accrue more to currently registered dealers with large or with small volumes and on whether the costs are more burdensome to currently unregistered firms with large or with small volumes. We believe the benefits would apply to all market participants alike. The quantitative factor in proposed Rule 3a44-2 would apply only to firms with Treasury-trading volume above the threshold. However, the qualitative factors may also apply to small-volume firms, and some costs may be greater for these firms on two points. First, FINRA's Gross Income Assessment<sup>289</sup> generally declines as a percentage of revenue for larger firms. Second, fees associated with reporting to TRACE<sup>290</sup> are smaller per dollar par value for larger trades.

<sup>286</sup> See also Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers, Exchange Act Release No. 68071 (Oct. 18, 2012), 77 FR 70213 (Nov. 23 2012).

<sup>287</sup> See *supra* note 216.

<sup>288</sup> See Letter from Alston Trading, LLC, RGM Advisors, LLC, Hudson River Trading, LLC, and Quantlab Financial, LLC (Apr. 23, 2010).

<sup>289</sup> See *supra* note 280.

<sup>290</sup> See *supra* note 271.

<sup>281</sup> See 2010 Equity Market Structure Concept Release.

<sup>282</sup> See Letter from Berkowitz, Trager & Trager, LLC (Apr. 21, 2010).

<sup>283</sup> See *supra* note 241 for further discussion of changes in trading activity of PTFs during the U.S. Treasury market volatility of March 2020.

<sup>284</sup> Although the analysis discussed in the baseline showed that registered dealers have much greater market share in the U.S. Treasury market (see *supra* Table 1 and note 217), PTFs are the largest participants in the automated interdealer Treasury market (see *supra* note 2).

<sup>285</sup> As previously described, the qualitative standards of the Proposed Rules apply to persons whose activities have "the effect of providing liquidity." See Section III.B.

### c. Effects on Capital Formation

The Proposed Rules' effect on capital formation may depend on any net change in market participation (aggregate trading volume) that results from the rules, and on any decrease or increase in competition among liquidity providers. Other things equal, higher volumes and more competition improve liquidity. In turn, greater liquidity increases asset prices, reduces borrowing costs, and promotes capital formation.

The likely effect on aggregate market participation is uncertain. On the one hand, we believe the increased regulatory burdens would fall on relatively few firms while the benefits of fairer and more stable markets would extend broadly to all market participants—since the baseline risk of an institution's failure would also propagate broadly by reducing market liquidity, increasing price volatility, or imposing losses on creditors. In the U.S. Treasury market, for example, we estimate that no more than 46 firms have dollar trading volumes that surpass the \$25 billion threshold in the quantitative standard of proposed Rule 3a44-2, as discussed in the baseline. The actual number of affected firms may be lower, since some of these 46 may be exempt financial institutions,<sup>291</sup> and still others may be affiliated with other firms that are dealers, in which case the corporate parent could potentially avoid the costs of the rule by shifting certain activities to the registered dealer affiliate.

On the other hand, the 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.

Changes in aggregate trading volume may also affect market liquidity in other ways. If the Proposed Rules increase investors' confidence in the stability and fairness of markets, they may increase their participation. Increased

trading volume theoretically enhances market liquidity because of the following two ways in which high volume benefits dealers.<sup>292</sup> First, dealers who trade a lot can spread their fixed costs over more trades. Second, dealers' risk is smaller when high volume makes it easier to adjust or lay off net positions. These benefits make liquidity provision more profitable, which results in narrower bid-ask spreads if dealers compete with one another for orders.

Effects on market competition can also influence market liquidity. If the Proposed Rules enhance competition, bid-ask spreads may decrease; if the Proposed Rules weaken competition, bid-ask spreads may increase. As discussed above, the net effect that the Proposed Rules would have on competition is uncertain.

### D. Reasonable Alternatives

The Commission considered several alternatives to the Proposed Rules: (1) Raise or lower the quantitative factor; (2) replace qualitative standards with quantitative standards; (3) remove the exclusion for registered investment companies; (4) remove the exclusion from aggregation for registered investment adviser client accounts where the advisers only have investment discretion; (5) exclude registered investment advisers; (6) exclude private funds; and (7) require private funds and private fund advisers to report transactions.

#### 1. Alternative Thresholds for the Quantitative Factor

The quantitative factor would require registration of all entities with monthly trading volume above \$25 billion during four out of the past six calendar months. A threshold lower than \$25 billion would increase the costs of the Proposed Rules (by requiring many more entities to register as dealers), but would only somewhat increase the benefits (since additional registrants would not represent very much aggregate trading volume). A threshold higher than \$25 billion would decrease both the benefits and the costs of the Proposed Rules (by requiring registration of fewer firms but failing to capture a significant portion of aggregate trading volume).

<sup>292</sup> See Larry Harris, "Trading and Exchanges: Market Microstructure for Practitioners," Oxford University Press, 2003.

Figure 2 shows the wide range of alternative thresholds that the Commission considered in an analysis<sup>293</sup> of U.S. Treasury-market transactions reported to TRACE during July 2021.<sup>294</sup> As described in the baseline, since the subset of TRACE data where we can verify the identity of the traders ("identified TRACE") is approximately 42 percent of all non-FINRA members' transactions in TRACE (many non-FINRA members only appear anonymously, also as described above), we believe that the thresholds in Figure 2 (based on identified TRACE) are approximately 42 percent of the equivalent threshold in the overall U.S. Treasury market. Therefore, the threshold of \$10 billion in Figure 2 corresponds with the Proposed Rules' quantitative threshold of \$25 billion.<sup>295</sup> Within identified TRACE, this figure shows the percentage of firms (dashed line) and the percentage of volume that would be captured by various quantitative thresholds. A threshold of \$10 billion would capture 26 percent of the firms and 96 percent of the volume in the identified TRACE data. Larger thresholds include many fewer firms but also considerably less trading volume—e.g., moving from a threshold of \$10 billion to \$50 billion would capture 32 fewer firms (18 percent of the 174 firms in the analysis) but also 15 percent less of the aggregate non-FINRA member trading volume in TRACE. Smaller thresholds include more firms but not very much additional volume—moving from a threshold of \$10 billion to \$5 billion would capture 8 more firms (5 percent of the 174 firms in the analysis) but only 1 percent more of the aggregate non-FINRA member trading volume in TRACE. The threshold that maximizes the Proposed Rule's benefits (by including firms responsible for a large percentage of trading volume) while minimizing costs (by limiting the number of firms that will be required to register) appears to be somewhere around \$10 billion.

<sup>293</sup> See *supra* note 217 and accompanying text.

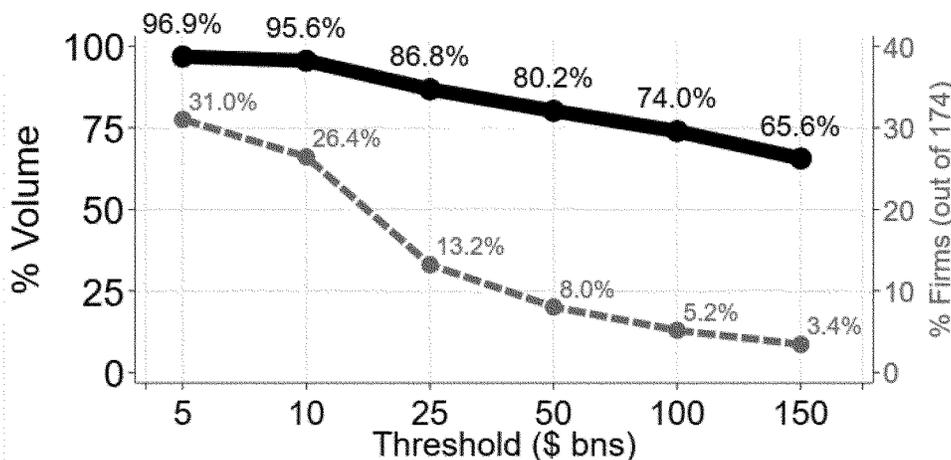
<sup>294</sup> The analysis also back-tested the thresholds to July 2019 and found that the results based on July 2021 data are qualitatively representative.

<sup>295</sup> We assume that all entities in identified TRACE are proportionally represented in the anonymous TRACE data. If firms engaging in dealer activities are overrepresented in identified TRACE, then the Proposed Rules' quantitative threshold of \$25 billion would correspond to a threshold in Figure 2 of higher than \$10 billion.

<sup>291</sup> See *supra* notes 9 and 29.

**Figure 2. Percent of Non-FINRA Member Volume and Non-FINRA Member Firms Captured by Various Volume Thresholds, July 2021**

For several potential monthly volume thresholds, this figure shows what percentage of identified non-FINRA member TRACE volume and what percentage of identified non-FINRA member firms would have crossed the threshold and so would have been required to register as dealers. “Identified” refers to the subset of TRACE data where regulators can observe the identities of non-FINRA member counterparties. This figure excludes all trading volumes and any firms that only appear in TRACE anonymously.



2. Provide Only Quantitative Factors

The Proposed Rules list several factors that will guide the Commission in determining whether securities market participants are dealers. With the exception of paragraph (a)(4) in proposed Rule 3a44-2—dollar volume of cash Treasury trading—all factors are qualitative. Alternatively, the Commission could replace the qualitative factors with quantitative “bright-line” thresholds, above or below which firms would be required to register as dealers. Particularly, the first qualitative factor (“routinely mak[es] roughly comparable purchases and sales of the same or substantially similar securities in a day”) could express a range of buy-sell balance, and firms could be required to register if their securities-trading activity features a buy-sell balance within that range.

The alternative rule could define buy-sell balance as the absolute value of (buy – sell)/(buy + sell), so that the measure would always fall between 0

(as when buy = sell) and 1 (as when a firm only buys or only sells). The buy-sell balance could then be calculated each day for each individual security (CUSIP), for each market participant. Any market participant with a buy-sell balance for a security that is below a quantitative threshold for a certain number of days per month could be required to register as a government securities dealer or as a dealer. For example, a firm whose buy-sell balance for CUSIP 78462F103 (SPDR S&P 500 ETF) that is below 0.2 for 13 days in a month could be required to register as a dealer, regardless of its buy-sell balance in other securities. The Proposed Rules could also have a *de minimis* cutoff, so that no market participant that trades less than, say, \$1 million per month could be required to register. The *de minimis* could help ensure that small, individual investors would not be required to register.

Table 6 below shows the number of market participants who would be

required to register under a few iterations of this alternative rule, based on the buy-sell balance of the highest-volume securities in the U.S. Treasury market (10-yr on-the-run note) and the equity market (SPDR S&P 00 ETF). The first row of data show that, if the rule were based on having a buy-sell balance of less than 0.2 (a 60–40 split or more even) for at least 14 days in a month, with a daily *de minimis* threshold of \$10,000, then the firms behind 61 CAT FDID institutional customer accounts would have to register as dealers based on their trading of SPY, and 20 firms (not necessarily the same ones) would have to register as government securities dealers based on their trading of the 10-yr on-the-run Treasury note. It is possible that additional firms would meet the proposed dealer definition based on their trading of other securities, but the securities in Table 6 are by far the largest in their respective classes (equities and Treasuries).

TABLE 6—NUMBER OF MARKET PARTICIPANTS SATISFYING QUANTITATIVE BUY-SELL BALANCE

De minimis volume (applied daily)	(buy – sell)/(buy + sell)	SPY	10-yr note (on-the-run)
\$10,000 .....	<0.2	61	20
	<0.1	44	15
\$100,000 .....	<0.2	57	20

TABLE 6—NUMBER OF MARKET PARTICIPANTS SATISFYING QUANTITATIVE BUY-SELL BALANCE—Continued

De minimis volume (applied daily)	(buy – sell)/(buy + sell)	SPY	10-yr note (on-the-run)
	<0.1	41	15

This table shows the number of firms that would be required to register based on the buy-sell balance of their trades of SPY (SPDR S&P 500 ETF, the highest-volume equity security) or the 10-yr on-the-run Treasury note (the highest-volume Treasury security). Specifically, the rule would require registration of firms with a buy-sell balance below a certain threshold for either of these securities, for 14 days in a month. The firms that satisfy the buy-sell balance factor based on SPY (column 1) are not necessarily the same as those that satisfy the factor based on the 10-yr note (column 2). Equity data is for October 2021, and market participants are identified by CAT FDID institutional customer accounts. CAT FDID institutional customer account is not synonymous with firm; a firm may have multiple CAT FDIDs, and multiple firms may also share a single CAT FDID. Furthermore, some of the CAT FDID customer accounts may represent investment companies registered under the Investment Company Act, which are not covered by the Proposed Rules. Treasury data is for July 2021.

We considered including “similar securities” in rule text and interpreting “similar securities” as including different CUSIPs that share similar characteristics—e.g., same issuer or same maturity. However, such an approach may be too broad, and may include a wide variety of arbitrage strategies or relative value strategies. For example, firms may trade securities with the same issuer and similar maturity when they arbitrage between on-the-run Treasuries against off-the-run Treasuries, or they may trade securities of similar issuers and similar characteristics when they take a long position in one company’s equity offset by a short position in a close competitor. Since we do not view such strategies as descriptive of being a dealer, this alternative to the Proposed Rules defines the buy-sell balance within CUSIP only.

Using quantitative factors instead of qualitative factors could provide firms with additional certainty as to whether they should register as dealers. However, we believe that a rule that relies solely on quantitative factors would be less capable of distinguishing firms that are liquidity providers from those that are not because at present we do not have a reliable quantitative framework for defining liquidity provision. Therefore, this alternative would likely require registration of some firms that are not liquidity providers or market-makers, thus burdening these firms with all of the registration costs described above without doing much to enhance market stability or improve regulators’ insight into market activity (since such firms do not play central market roles); and the alternative may also miss some firms that do provide liquidity, thus allowing them to continue operating without registering, as in the baseline.

### 3. Remove Exclusion for Registered Investment Companies

The Proposed Rules explicitly exclude registered investment companies. An alternative would be to

remove this exclusion, as it is possible that these entities might satisfy the criteria and, collectively or individually, might be important liquidity providers in securities markets. Requiring them to register as dealers might further standardize the books and records practices of market liquidity providers and, to the extent that registered investment companies were to choose FINRA as their SRO, their registration might contribute toward the completeness of fixed-income transaction reporting in TRACE. For non-municipal securities, additional TRACE reporting would enhance market stability by supporting regulators’ ability to research, understand, and respond to market events; for non-government and non-municipal securities, additional TRACE reporting would also better inform investors. If, instead of registering as dealer, registered investment companies were to cease the activities that satisfy the Proposed Rules’ standards, these benefits would not materialize.

This alternative would also lead to significant costs and uncertainty. Registered investment companies have different business models and serve different market purposes than PTFs or hedge funds, and the regulatory regime that has evolved around liquidity providers might be inadequate or inappropriate for registered investment companies. As one example, it is unclear how registered investment companies would comply with net capital requirements, or how they would define net capital. Moreover, the benefits of the proposals as applied to registered investment companies would be significantly lower than for PTFs because registered investment companies are subject to an extensive regulatory framework based on the Investment Company Act and associated rules.<sup>296</sup>

We believe that affected parties will not have sufficient incentives to evade

the proposal by registering as a registered investment company, because the requirements to be a registered investment company are sufficiently similar to the proposal. For example, registered investment companies must be securities issuers, they are significantly constrained in their ability to borrow, and they are subject to limitations on their derivatives positions. We understand that leverage and derivatives are integral parts of the types of trading strategies that would satisfy the Proposed Rules’ standards. Moreover, registered investment companies are required to disclose details regarding their portfolio holdings. We acknowledge that the costs and benefits of applying the Proposed Rules to registered investment companies may differ from applying them to other market participants, and we request comment on the costs and benefits of excluding registered investment companies.

### 4. Remove the Exclusion From Aggregation for Registered Investment Adviser Client Accounts Where the Advisers Only Have Investment Discretion

A registered investment adviser may have client accounts (including private funds and separately managed accounts) that are not registered as dealers but whose activity individually or collectively satisfies the Proposed Rules’ activity standards. The Proposed Rules would not attribute the activities of those accounts to the registered investment adviser if the adviser’s control over the accounts simply involves investment discretion. The Proposed Rules would require the registered investment adviser to aggregate client accounts if it exercises certain control rights over the accounts (voting rights, capital contributions, or rights to amounts upon dissolution).<sup>297</sup> Alternatively, the rule could require registered investment advisers to

<sup>296</sup> See *supra* notes 104–114 and accompanying text.

<sup>297</sup> See text in proposed Rules 3a5–4(b)(2)(ii)(B) and 3a44–2(b)(2)(ii)(B).

aggregate client accounts over which the adviser only has investment discretion, so that all advisers would need to aggregate all of their (non-dealer) discretionary accounts in order to determine whether their activities fall under the Proposed Rules.

This alternative would strengthen the benefits described above by applying more broadly the leverage constraints and transaction reporting requirements of the dealer regulations. If advisers or their funds were to avoid registration by reducing or ceasing certain trading activities, the marginal benefits of this alternative could still materialize if registered dealers then increased their own activities to compensate. This alternative would further promote market stability by ensuring that liquidity-providing activities are conducted by entities that maintain minimum levels of net capital. The alternative would result in a greater number of liquidity-providing transactions being directly reported to TRACE (to the extent that new dealer registrants choose FINRA as their SRO) or to CAT, which would enhance market stability by supporting regulators' ability to research, understand, and respond to market events. For non-government and non-municipal fixed-income securities, additional TRACE reporting would also better inform investors since FINRA disseminates those data publicly. The benefits of TRACE reporting would not appear for new dealer registrants choosing another SRO, such as a stock exchange.

However, this alternative would also carry disadvantages, including greater regulatory costs and possible negative effects on market liquidity, efficiency, and competition. Regulatory costs, including those associated with registration, reporting, and maintaining net capital, would increase for any new dealer registrants, but self-assessment costs would also increase for advisers that must continually determine their obligations under the Proposed Rules. If advisers or their accounts were to avoid registration by reducing or ceasing certain trading activities, and if registered dealers did not then increase their own activities to compensate, then market efficiency and liquidity may decline. Also, aggregating all discretionary accounts for the purposes of determining an adviser's obligations under the Proposed Rules may reduce efficiency by creating incentives against economies of scale associated with large advisers. Finally, competition among liquidity providers may decline, but we believe that liquidity provision in U.S.

security markets would remain reasonably competitive.

Relative to the Proposed Rules, this alternative would primarily apply dealer regulations to smaller private funds or separately managed accounts (via their advisers), since larger funds and their advisers are more likely to be covered under the Proposed Rules. These benefits of new leverage constraints and additional transaction reporting would be small for such funds, while the funds would still bear all the registration and compliance costs described above. Therefore, we believe the additional benefits of this alternative would not justify the additional costs.

#### 5. Exclude Registered Investment Advisers

The Proposed Rules do not aggregate registered investment advisers' client accounts (including private funds or separately managed accounts) and attribute their activity to the adviser, as long as the adviser's control over the accounts is limited to investment discretion. Accounts over which the adviser's control rights include voting rights, capital contributions, or the rights to amounts upon dissolution would be aggregated and attributed to the adviser in determining whether the Proposed Rules would require the adviser to register as a dealer.<sup>298</sup> Registered investment advisers can also trigger application of the Proposed Rules due to their own proprietary trading. Alternatively, the Commission could propose an exclusion for all registered investment advisers.

The additional exclusion would reduce the benefits described above, since it would limit the Proposed Rules' ability to raise the share of liquidity provision conducted by firms that are subject to the dealer rule. The Proposed Rule would do so by: (i) Inducing additional liquidity providers to register as dealers; or (ii) inducing liquidity providers who do not wish to register as dealers to cease their liquidity-providing strategies. If registered investment advisers categorically were excluded, it is likely that fewer of them would register and that fewer of them would register client accounts in order to avoid aggregating those accounts' activities. Although registered advisers would still be subject to the existing regulations described above, including conduct rules, books and records requirements, reporting requirements, and examinations, their exclusion would undermine the Proposed Rules' benefits related to net capital

<sup>298</sup> See text in proposed Rules 3a5-4(b)(2)(ii)(B) and 3a44-2(b)(2)(ii)(B).

requirements and to transaction reporting.

This alternative would also reduce the costs, since fewer entities would be subject to the dealer regime and fewer entities would be induced to exit certain trading strategies in order to avoid the dealer regime. The potential negative effects on market liquidity, efficiency, and competition would therefore be smaller under this alternative.

However, a blanket exclusion may exclude, now or in the future, a large adviser whose client accounts, if aggregated, would meet the standards of the Proposed Rules and provide significant liquidity in the securities markets. Also, we are concerned that this alternative rule might lead a PTF to seek to register as an investment adviser rather than as a dealer, in order to escape the requirements to report transactions and maintain net capital. The regulations that apply to registered investment companies place greater restrictions on leverage and derivatives positions than do the regulations that apply to registered investment advisers, so it would be unlikely that PTFs would seek to register as investment companies. Due to the way in which this alternative compromises the Proposed Rules' benefits related to net capital requirements and transaction reporting, and due also to the possibility for regulatory arbitrage, we believe the benefits of this alternative do not justify the costs.

#### 6. Exclude Private Funds

The Proposed Rules do not exclude private funds, since we believe some private funds—particularly some hedge funds—engage in activities that have the effect of providing liquidity in securities market. The Commission could explicitly exclude private funds in order to avoid deterring certain fund strategies that may not be indicative of securities dealing. This exclusion would potentially reduce some of the benefits that would accrue if the Proposed Rules were to capture liquidity-providing activities—either because funds who satisfy the qualitative or quantitative standards register, or else because funds who satisfy the standards exit certain strategies to avoid registration and other (registered) dealers then arise to replace the lost activity. Excluding private funds would also reduce the costs of lost liquidity and reduced market efficiency that could materialize if affected private funds exit certain strategies without being replaced.

However, the Commission believes that some private funds effectively provide liquidity in securities markets, and the Proposed Rules' intent is to

apply dealer regulation to these activities. Excluding these funds would guarantee that the dealer regime would fail to capture this type of securities dealing activity. Furthermore, a blanket exclusion for hedge funds may provide an opportunity for regulatory arbitrage. For example, PTFs may seek to restructure themselves as private funds, thus preempting the intended benefits of the Proposed Rules. This may be particularly true given the similarity in incentive structures mentioned above.

Despite the high degree of uncertainty around private funds and the possible negative effects of requiring some private funds to register as dealers, the Commission believes that not excluding them is more likely to meet the Proposed Rules' objectives than excluding them. We therefore believe the costs of excluding private funds are justified by the potential benefits.

#### 7. Transaction Reporting Regime for Private Funds and Private Fund Advisers

As described above, private funds and private fund advisers not registered as dealers are not subject to the requirement to report transactions to TRACE. Alternatively, the Commission could require 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. However, 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. It would also entail greater complexity in the need to specify how alternative entities would become subject to TRACE reporting.

This alternative would reduce key benefits of the proposal, but it would also reduce some of the costs related to registration, compliance with requirements other than transaction reporting to TRACE, and self-evaluation. We do not believe the reduced costs justify the reduced benefits.

#### E. Requests for Comment

The Commission requests comment on all aspects of this initial economic analysis, including whether the analysis has: (1) Identified all benefits and costs, including all effects on efficiency, competition, and capital formation; (2) given due consideration to each benefit and cost, including each effect on

efficiency, competition, and capital formation; and (3) identified and considered reasonable alternatives to the proposed new rules and rule amendments. We request and encourage any interested person to submit comments regarding the Proposed Rules, our analysis of the potential effects of the Proposed Rules and proposed amendments, and other matters that may have an effect on the Proposed Rules. We request that commenters identify sources of data and information as well as provide data and information to assist us in analyzing the economic consequences of the Proposed Rules and proposed amendments. We also are interested in comments on the qualitative benefits and costs we have identified and any benefits and costs we may have overlooked. In addition to our general request for comments on the economic analysis associated with the Proposed Rules and proposed amendments, we request specific comment on certain aspects of the proposal:

#### Baseline

57. Are firms that are not registered as dealers or as government securities dealers important participants in securities market? If so, in which markets and in what ways? Do commenters agree that such firms have emerged as *de facto* liquidity providers?

58. The quantitative factor in proposed Rule 3a44-2 would identify as government securities dealers persons that trade more than \$25 billion of Treasury securities monthly, during four out of the past six calendar months. Do you agree that approximately 46 firms would be government securities dealers based on this standard? Responses should provide empirical support, if possible.

59. One of the rules' qualitative factors would identify as dealers and government securities dealers persons that "routinely [make] roughly comparable purchases and sales of the same or substantially similar securities in a day." Approximately how many firms would be dealers or government securities dealers based on this factor? Responses should provide empirical support, if possible.

60. Do you agree that PTFs have emerged as *de facto* liquidity providers in the market for U.S. Treasury securities? To what extent do PTFs also provide liquidity in other securities markets?

61. Do you agree with the Commission's description of the potential market disruptions that may follow the failure of one or more market participants that are not registered as

dealers—*i.e.*, the potential negative effects on creditors, counterparties, market liquidity, and market volatility? Why or why not?

62. Do you agree with the Commission's description of the externality that arises due to the possibility of manipulative or fraudulent behavior? Why or why not?

63. Do you agree with the Commission's statement that the lack of regulatory insight into the practices and transactions of unregistered market participants negatively impacts markets by constraining regulators' ability to understand and respond to significant market events? Why or why not?

#### Economic Effects, Including Impact of Efficiency, Competition, and Capital Formation

64. Do you agree that the Proposed Rules would promote investor protection and orderly markets by increasing the financial stability and resiliency of individual liquidity providers in securities markets, particularly those liquidity providers that are not registered with the Commission? Why or why not?

65. Do you agree that the Proposed Rules would promote investor protection and orderly markets by better informing regulators through more comprehensive transaction reporting, annual filings by newly registered dealers, and examinations?

66. Do you agree that the Proposed Rules would deter manipulation or fraud behavior, by improving the Commission's ability to detect it? Why or why not?

67. Do you agree with the Commission's description of the direct costs incurred by new registrants—*e.g.*, costs of registering, costs of SRO membership, costs of reporting, etc.? Why or why not?

68. Do you agree that the Proposed Rules would have offsetting positive and negative effects on market participation, market liquidity, price efficiency, competition among liquidity providers, and capital formation? Are the overall effects on each of these likely to be positive or negative? Please explain.

69. How will firms that register as dealers in response to the Proposed Rules bring themselves into compliance with the net capital requirements? Please provide details regarding how the new dealers will implement and manage their compliance.

70. Do you expect market participants, especially those captured by the Proposed Rules, to alter their legal structures? What changes are they

likely to make and what effects will those changes have?

71. Do you expect some market participants, whom the Proposed Rules would otherwise require to register as dealers, to reduce or exit certain activities in order to avoid the requirement to register? What types of entities would do so, and which activities would be affected?

Reasonable Alternatives

72. What benefits or costs would result from setting the threshold on the quantitative factor higher or lower than \$25 billion monthly volume during four out of the past six calendar months?

73. What benefits or costs would result from limiting the quantitative threshold by incorporating other characteristics of trading activity, such as turnover or balance of buys and sells? For instance, an alternative quantitative standard could require firms to register as dealers if they met BOTH a dollar volume threshold and a turnover threshold; another alternative standard could require firms to register if they

meet BOTH a buy-volume threshold and a sell-volume threshold.

74. What benefits or costs would result from replacing the qualitative factors with quantitative “bright-line” thresholds?

75. What benefits and costs would result from removing the exclusion for registered investment companies? How would these benefits and costs differ from the benefits and costs described above?

76. What benefits or costs would result from removing the exclusion for registered investment advisers that only have investment discretion over client funds?

77. What benefits or costs would result from excluding private funds?

78. Are there other reasonable alternatives to the Proposed Rules that the Commission has not addressed? Commenters should describe any additional alternatives, along with the benefits and costs relative to the Proposed Rules.

**VI. Paperwork Reduction Act**

The Proposed Rules would define terms and do not in and of themselves

contain “collection of information” requirements within the meaning of the Paperwork Reduction Act of 1995 (“PRA”).<sup>299</sup> However, the new definitions may affect the number of respondents that meet the “collection of information” requirements in other Commission rules. The Commission believes the Proposed Rules may affect the number of respondents for 14 Commission rules with existing collections of information. The potential changes in burden under the Office of Management and Budget (“OMB”) Control Numbers corresponding to the existing collections of information are explained in more detail below. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the agency displays a currently valid control number. If the new definitions in the Proposed Rules are adopted, the Commission will submit change requests to OMB to update the number of respondents for these 14 other rules. The titles of these existing collections of information are:

Rule	Rule title	OMB control No.
17 CFR 240.15b1-1 (Rule 15b1-1) and Form BD 17 CFR 240.15Ca1-1 (Rule 15Ca1-1) and Form BD.	Application for registration of brokers or dealers ..... Notice of government securities broker-dealer activities.	3235-0012
17 CFR 240.15Ca2-1 (Rule 15Ca2-1) and Form BD. 17 CFR 240.15b3-1 (Rule 15b3-1) ..... 17 CFR 240.15b6-1 (Rule 15b6-1) and Form BDW.	Application for registration of government securities brokers or government securities dealers. Amendments to application. Withdrawal from registration .....	3235-0018
17 CFR 240.15Cc1-1 (Rule 15Cc1-1) and Form BDW. 17 CFR 240.15c2-7 (Rule 15c2-7) .....	Withdrawal from registration of government securities brokers or government securities dealers. Identification of quotations .....	3235-0479
Rule 15c3-1 .....	Net capital requirements for brokers and dealers .....	3235-0200
Rule 15c3-5 .....	Risk management controls for brokers or dealers with market access .....	3235-0673
Rule 17a-3 .....	Records to be made by certain exchange members, brokers, and dealers ..	3235-0033
Rule 17a-4 .....	Records to be preserved by certain members, brokers, and dealers .....	3235-0279
Rule 17a-5 .....	Reports to be made by certain exchange members, brokers and dealers ...	3235-0123
17 CFR 240.17a-11 (Rule 17a-11) .....	Notification provisions for brokers and dealers .....	3235-0085
17 CFR 242.613 (Rule 613) .....	Consolidated audit trail .....	3235-0671

*A. Summary of Collection of Information*

The Proposed Rules create burdens under the PRA by adding additional

respondents to some of the 10 existing collections of information noted above. The Proposed Rules would not create any new collections of information. The

collections of information applicable to the additional respondents<sup>300</sup> are summarized in the table below.

Collection of information	Burden
Rule 15b1-1 and Form BD .....	Register as a dealer (required by Section 15 of the Exchange Act).
Rule 15Ca1-1 and Form BD .....	Notification requirement that a dealer is acting as a government securities dealer.
Rule 15Ca2-1 and Form BD <sup>301</sup> .....	Register as a government securities dealer (required by Section 15C of the Exchange Act).
Rule 15b3-1 .....	Comply with requirements to amend Form BD.
Rule 15b6-1 and Form BDW .....	File a notice of withdrawal using Form BDW.
Rule 15Cc1-1 and Form BDW <sup>302</sup> ..	File a notice of withdrawal using Form BDW.
Rule 15c2-7 .....	Enumerates certain criteria that broker-dealers must meet to furnish a quotation for a security to an inter-dealer quotation system.

<sup>299</sup> 44 U.S.C. 3501 *et seq.*

<sup>300</sup> See Section VI.C for a description of the categories of respondents.

Collection of information	Burden
Rule 15c3-1 .....	Comply with notification and record-keeping obligations concerning capital requirements set for brokers-dealers.
Rule 15c3-5 .....	Comply with requirements to establish and maintain risk management and supervisory procedures.
Rule 17a-3 .....	Comply with requirements to make and keep certain business records.
Rule 17a-4 .....	Comply with requirements to keep certain records.
Rule 17a-5 .....	Comply with requirements to make, keep, and report certain records.
Rule 17a-11 .....	Comply with notification requirements concerning broker-dealers that are experiencing certain financial or operational difficulties.
Rule 613 .....	Comply with requirements to report certain information.

*B. Proposed Use of Information*

The existing information collections affected by the Proposed Rules are used as described below:

1. Rules 15b1-1, 15Ca-1, 15Ca2-1, and 15b3-1 and Form BD

Section 15(a)(1) of the Exchange Act provides that it is unlawful for broker-dealers to solicit or effect transactions in most securities unless they are registered as broker-dealers with the Commission pursuant to Section 15(b) of the Exchange Act. In addition, Section 15C(a)(1) of the Exchange Act provides that it is unlawful for government securities broker-dealers, other than registered broker-dealers and certain financial institutions, to solicit or effect transactions in government securities unless they are registered as government securities broker-dealers with the Commission pursuant to Section 15C(a)(2) of the Exchange Act. To implement these provisions, the Commission adopted Rules 15b1-1, 15Ca-1, and 15Ca2-1 and Form BD. In addition, Rule 15b3-1 requires a broker-dealer to file amendments to Form BD only when information originally reported in Form BD changes or becomes inaccurate.

The Commission uses the information disclosed by applicants in Form BD: (1) To determine whether the applicant meets the standards for registration set forth in the provisions of the Exchange Act; (2) to develop a central information resource where members of the public may obtain relevant, up-to-date information about broker-dealers and government securities broker-dealers, and where the Commission, other regulators, and SROs may obtain information for investigatory purposes in connection with securities litigation; and (3) to develop statistical

information about broker-dealers and government securities broker-dealers. Without the information disclosed in Form BD, the Commission could not effectively implement policy objectives of the Exchange Act with respect to its investor protection function.

2. Rules 15b6-1 and 15Cc-1 and Form BDW

Section 15(b)(5) of the Exchange Act provides that any broker-dealer may, upon such terms and conditions as the Commission deems necessary or appropriate in the public interest or for the protection of investors, withdraw from registration by filing a written notice of withdrawal with the Commission. In addition, Section 15C(c)(1)(B) of the Exchange Act provides that any government securities broker or government securities dealer may, upon such terms and conditions as the Commission may deem necessary in the public interest or for the protection of investors, withdraw from registration by filing a written notice of withdrawal with the Commission. To implement the foregoing statutory provisions of the Exchange Act, the Commission has promulgated Rules 15b6-1 and 15Cc1-1, as well as Form BDW, the uniform request for broker-dealer withdrawal.

The Commission uses the information disclosed by applicants in Form BDW, as required by Rules 15b6-1 and 15Cc1-1 to: (1) Determine whether it is in the public interest to permit broker-dealers and notice-registered broker-dealers to withdraw from registration; (2) develop central information resources where the Commission and other government agencies and SROs may obtain information for investigatory purposes in connection with securities litigation; and (3) to develop statistical information about broker-dealers, notice-registered broker-dealers, and government securities broker-dealers. Without Form BDW, the Commission, SROs, state regulators, the Commodity Futures Trading Commission, and the public would be without an important source of information regarding broker-dealers and notice-registered broker-

dealers that are seeking to withdraw from registration.

3. Rule 15c2-7

The information required by Rule 15c2-7 is necessary for the Commission's mandate under the Exchange Act to prevent fraud, manipulation and deceptive acts and practices. When Rule 15c2-7 was adopted, the information it required was critical to the Commission's role in monitoring broker-dealers and protecting the integrity of over the counter markets. It was through the disclosures required by Rule 15c2-7 that inter-dealer quotation systems would reflect the demand for and market activity related to the securities quoted on these systems.

4. Rule 15c3-1

Rule 15c3-1 is intended to help ensure that broker-dealers maintain at all times sufficient liquid resources to meet all liabilities by requiring that broker-dealers maintain a minimum amount of net capital. A broker-dealer's minimum net capital requirement is the greater of: (1) A fixed minimum amount set forth in Rule 15c3-1 based on the types of business that the broker-dealer conducts; or (2) a financial ratio. Exchange Act Section 15(c)(3) and Rule 15c3-1 promulgated thereunder prohibit a broker-dealer from effecting transactions in securities while not in compliance with its minimum net capital requirement.

Various provisions of Rule 15c3-1 require that broker-dealers provide written notification to the Commission and/or their designated examining authority ("DEA") under certain circumstances. For example, a broker-dealer must send notice to the Commission if it withdraws more than 10 percent or 20 percent of its excess net capital. In addition, a broker-dealer electing to compute its net capital using the alternative method under paragraph (a)(1)(ii) of Rule 15c3-1 must notify its DEA of the election in writing, and thereafter must continue to compute its net capital in this manner unless a change is approved upon application to

<sup>301</sup> Financial institutions that are government securities dealers not exempt under 17 CFR part 401 must use Form G-FIN to notify their appropriate regulatory agency of their status as a government securities dealer. See 17 CFR 449.1.

<sup>302</sup> Financial institutions that are government securities dealers must use Form G-FINW to notify their appropriate regulatory agency that they have ceased to function as a government securities broker or dealer. See 17 CFR 449.2.

the Commission. Further, there are special notification requirements for broker-dealers that carry the accounts of options market makers to identify when the activities of those options market makers may impact the financial stability of the carrying broker-dealer.

There are also certain recordkeeping requirements under Rule 15c3-1. For example, a broker-dealer must keep a record of who is acting as an agent in a securities loan transaction and records with respect to obtaining DEA approval prior to withdrawing capital within one year of a contribution. These records help the Commission and its staff, as well as DEAs, facilitate the monitoring of the financial condition of broker-dealers.

The provision at 17 CFR 240.15c3-1c (appendix C to Rule 15c3-1) requires broker-dealers that consolidate their financial statements with a subsidiary or affiliate, under certain circumstances, to submit to their DEA an opinion of counsel. The opinion of counsel must state, among other things, that the broker-dealer may cause that portion of the net assets of a subsidiary or affiliate related to its ownership interest in the entity to be distributed to the broker-dealer within 30 calendar days.

#### 5. Rule 15c3-5

Rule 15c3-5 seeks to ensure that broker-dealers with market access appropriately control the risks associated with market access, so as not to jeopardize their own financial condition, that of other market participants, the integrity of trading on the securities markets, and the stability of the financial system.<sup>303</sup>

#### 6. Rule 17a-3

The purpose of requiring broker-dealers to create the records specified in Rule 17a-3 is to enhance regulators' ability to protect investors. These records and the information contained therein will be and are used by examiners and other representatives of the Commission, State securities regulatory authorities, and the self-regulatory organizations (e.g., FINRA, CBOE, etc.) ("SROs") to determine whether broker-dealers are in compliance with the Commission's antifraud and anti-manipulation rules, financial responsibility program, and other Commission, SRO, and State laws, rules, and regulations. If broker-dealers were not required to create these records, Commission, SRO, and state examiners would be unable to conduct effective and efficient examinations to determine whether broker-dealers were

complying with relevant laws, rules, and regulations.

#### 7. Rule 17a-4

The purpose of requiring broker-dealers to maintain the records specified in Rule 17a-4 is to help ensure that examiners and other representatives of the Commission, State securities regulatory authorities, and SROs have access to the information and documents necessary to determine whether broker-dealers are in compliance with the Commission's antifraud and anti-manipulation rules, financial responsibility program, and other Commission, SRO, and State laws, rules, and regulations. Without Rule 17a-4, it would be impossible for the Commission to determine whether a dealer that chose not to preserve records was in compliance with these rules. Such a situation would not be in the public interest and would be detrimental to investors and the financial community as a whole.

#### 8. Rule 17a-5

Reports required to be made under Rule 17a-5 are used, among other things, to monitor the financial and operational condition of a broker-dealer by Commission staff and by the dealer's DEA. The reports required under Rule 17a-5 are one of the primary means of ensuring compliance with the financial responsibility rules. A firm's failure to comply with these rules would severely impair the ability of the Commission and the firm's DEA to protect customers. The reported data is used in preparation for broker-dealer examinations and inspections. The completed forms also are used to determine which firms are engaged in various securities-related activities, the extent to which they are engaged in those activities, and how economic events and government policies might affect various segments of the securities industry.

#### 9. Rule 17a-11

The information obtained under Rule 17a-11 is used to monitor the financial and operational condition of a broker-dealer by the Commission staff, by the broker-dealer's DEA and, if applicable, by the Commodity Futures Trading Commission ("CFTC"). This information alerts the Commission, the DEA, and the CFTC of the need to increase surveillance of the broker-dealer's financial and operational condition and to assist the broker-dealer to comply with the Commission's rules. No similar information is already available to use or modify for purposes of complying with Rule 17a-11 because the disclosures required by the rule are

unobtainable until the early warning mechanisms are triggered. Only the most up-to-date information will help the Commission, DEAs, and the CFTC to monitor broker-dealers experiencing financial or operational difficulties.

#### 10. Rule 613

Rule 613 creates a comprehensive CAT that allows regulators to efficiently and accurately track all activity throughout the U.S. markets in certain securities.<sup>304</sup> The rule specifies the type of data to be collected and when the data is to be reported to a central repository. The information collected and reported to the central repository improves the quality of the data available to regulators and could be used by regulators to monitor and surveil the securities markets and detect and investigate activity, whether on one market or across markets. The data collected and reported to the central repository could also be used by regulators for the evaluation of tips and complaints and for complex enforcement inquiries or investigations, as well as inspections and examinations. Further, regulators could use the data collected and reported to conduct more timely and accurate analysis of market activity for reconstruction of broad-based market events in support of regulatory decisions.

#### C. Respondents

As discussed above, proposed Rules 3a5-4 and 3a44-2 would further define activities that would cause a person engaged in the regular business of buying and selling securities for its own account within the meaning of the Exchange Act. A person who satisfies any one of the factors set forth in either of the Proposed Rules would be a dealer or government securities dealer and so required to register, absent an exception or exemption.

#### 1. Dealers

The qualitative factors identified in proposed Rule 3a5-4 would further define dealer activity. The Commission estimates that for proposed Rule 3a5-4 the total number of respondents that would register as a dealer would be approximately 51 persons.<sup>305</sup> The

<sup>304</sup> See 17 CFR 242.613.

<sup>305</sup> This estimate is based on the analysis described in Section V.B.2. As identified in Table 4, the analysis indicates that between 41 and 61 CAT FDID institutional customer accounts (depending on the thresholds used) had both low buy-sell dollar volume imbalance in SPY and above *de minimis* total dollar volume in SPY in at least 14 of 21 trading days in October 2021. See Section V.B.2. Although there is currently no simple one-

<sup>303</sup> See 17 CFR 240.15c3-5(a)(1).

Commission estimates that respondents will be subject to some or all of the following collections of information as estimated below.

## 2. Government Securities Dealers

The Commission estimates that, as a result, for proposed Rule 3a44–2 the total number of respondents that would register as a government securities dealer with the Commission would be approximately 46 persons<sup>306</sup> and that some of the respondents may elect to register as a dealer under Section 15(a), rather than as a government securities dealer under Section 15C.<sup>307</sup> The Commission estimates that respondents will be subject to some or all of the following collections of information as estimated below.

### D. Total PRA Burdens

#### 1. Burden of Rules 15b1–1, 15Ca–1, 15Ca2–1, and 15b3–1 and Form BD

As discussed above, Section 15C of the Exchange Act requires government securities dealers to register with the Commission.<sup>308</sup> A government securities dealer has the flexibility to either register as a dealer pursuant to Rule 15b1–1 and file notice as a government securities dealer under Rule 15Ca–1, or register as a government

to-one correspondence between the number of CAT FDID customer accounts that satisfy various thresholds in Table 4 and the number of unregistered market participants in the market (*e.g.*, some unregistered market participants may have several CAT FDID accounts, and some CAT FDID accounts may represent more than one customer), the Commission believes that the analysis in Table 4 provides a useful indication about the scope of a potential impact of proposed Rule 3a5–4 and has used the median of the results at Table 4 to determine the number of approximate market participants that would register as a dealer as a result of proposed Rule 3a5–4. Additionally, the Commission recognizes that some of the 41 to 61 CAT FDID institutional customer accounts may be held by registered investment companies that are excluded from the Proposed Rules.

<sup>306</sup> This estimate is based on the analysis described in Section V.B.2. That analysis found that 46 non-FINRA member firms would likely meet the proposed quantitative standard. The Commission recognizes that some of these firms may be exempted from registration (*e.g.*, banks) or affiliated with other entities that are registered dealers, in which case a parent entity could avoid the costs of registration by shifting the activities covered by the Proposed Rules to the registered dealer affiliate.

<sup>307</sup> See Section VI.D.1. Respondents that register with the Commission as a dealer or government securities dealer file a Form BD. Respondents that are government securities dealer are subject to the rules governing government securities dealers promulgated by the U.S. Treasury at 17 CFR parts 400 through 499. See 15 U.S.C. 78o–5(b); see also 17 CFR parts 400 through 499. The Treasury Rules, for the most part, incorporate with some modifications the Commission's rules for government securities dealers that are not financial institutions. See *supra* note 81.

<sup>308</sup> See 15 U.S.C. 78o–5(a).

securities dealer under Rule 15Ca2–1.<sup>309</sup> In either case, the respondent is required to complete a Form BD.<sup>310</sup> The Commission believes that Proposed Rules would impose the same burden to the respondents irrespective of whether the respondent registers as a dealer or a government securities dealer. Once registered, a broker-dealer must file an amended Form BD when information it originally reported on Form BD changes or becomes inaccurate.<sup>311</sup> The Commission estimates an initial burden of 2.75 hours<sup>312</sup> for completing a Form BD and an annual burden of .95 hour<sup>313</sup> per respondent for amending Form BD, resulting in a total initial burden of 266.75 hours<sup>314</sup> and a total annual burden of 76.95 hours.<sup>315</sup>

In addition, the Commission believes that a respondent's compliance manager would complete and file the application and amendments on Form BD at \$314/hour.<sup>316</sup> Consequently, the Commission estimates that the internal cost of compliance associated with these burden hours for the respondents is approximately an initial burden of

<sup>309</sup> Compare 15 U.S.C. 78o(a) with 15 U.S.C. 78o–5(a). A government securities dealer that registers under Section 15C(a)(1)(A) will be limited to conducting a government securities business only.

<sup>310</sup> Compare 17 CFR 240.15b1–1(a) (“An application for registration of a broker or dealer that is filed pursuant to section 15(b) of the Act (15 U.S.C. 78o(b)) shall be filed on Form BD (249.501 of this chapter) in accordance with the instructions to the form”) and 17 CFR 240.15Ca1–1(a) (“Every government securities broker or government securities dealer that is a broker or dealer registered pursuant to section 15 or 15B of the Act (other than a financial institution as defined in section 3(a)(46) of the Act) shall file with the Commission written notice on Form BD (249.501 of this chapter) in accordance with the instructions contained therein that it is a government securities broker or government securities dealer.”) with 17 CFR 240.15Ca2–1(a) (“An application for registration pursuant to Section 15C(a)(1)(A) of the Act, of a government securities broker or government securities dealer that is filed on or after January 25, 1993, shall be filed with the Central Registration Depository (operated by the Financial Industry Regulatory Authority, Inc.) on Form BD in accordance with the instructions contained therein.”).

<sup>311</sup> See 17 CFR 240.15b3–1.

<sup>312</sup> See Extension Without Change of a Currently Approved Collection: Form BD and Rule 15b1–1; Application for Registration as a Broker-Dealer; ICR Reference No. 201905–3235–016; OMB Control No. 3235–0012 (Aug. 7, 2019), available at [https://www.reginfo.gov/public/do/PRAViewDocument?ref\\_nbr=201905-3235-016](https://www.reginfo.gov/public/do/PRAViewDocument?ref_nbr=201905-3235-016) (“Form BD PRA Supporting Statement”).

<sup>313</sup> The Commission's currently approved burden for the average ongoing compliance burden for each respondent amending Form BD is .95 hours (Compliance Manager at 0.33 hours × 2.87 amendments per year). See Form BD PRA Supporting Statement at 5.

<sup>314</sup> 97 respondents multiplied by 2.75 hours per respondent.

<sup>315</sup> 97 respondents multiplied by .95 hours per respondent.

<sup>316</sup> Form BD PRA Supporting Statement at 5.

\$83,759.50<sup>317</sup> and an annual burden of \$28,935.10.<sup>318</sup> It is not anticipated that respondents will have to incur any capital and start-up costs, nor any additional operational or maintenance costs, to comply with the collection of information.<sup>319</sup>

#### 2. Burden of Rules 15b6–1 and 15Cc–1 and Form BDW

The time necessary to complete and file Form BDW will vary depending on the nature and complexity of the applicant's securities business. On average, the Commission estimates that it would take a broker-dealer approximately one hour<sup>320</sup> per respondent to complete and file a Form BDW to withdraw from Commission registration. The Commission estimates that at least one of the 97 respondents will withdraw as a dealer, resulting in a total annual burden of one hour.<sup>321</sup> The Commission believes that a respondent would have a compliance officer, at \$536 per hour, complete and file the Form BDW to withdraw from Commission registration.<sup>322</sup> Accordingly, the Commission estimates an internal compliance cost associated with the burden hours for the respondents is approximately \$536.<sup>323</sup> It is not anticipated that respondents will have to incur any capital and start-up costs, nor any additional operational or maintenance costs, to comply with the collection of information.<sup>324</sup>

#### 3. Burden of Rule 15c2–7

Any broker-dealer could be a potential respondent for Rule 15c2–7. Only quotations entered into an inter-dealer quotation system such as OTC Link, OTC Bulletin Board (OTCBB), and Global OTC, are covered by Rule 15c2–7. According to representatives of OTC Link, Global OTC, and the OTCBB, none of those entities has recently received, nor anticipates receiving, any Rule 15c2–7 notices.<sup>325</sup> However, because

<sup>317</sup> 97 respondents multiplied by (2.75 initial hours per respondent multiplied by \$314 per hour).

<sup>318</sup> 97 respondents multiplied by (.95 annual hours per respondent multiplied by \$314 per hour).

<sup>319</sup> Form BD PRA Supporting Statement at 6.

<sup>320</sup> See Extension Without Change of a Currently Approved Collection: Rule 15b6–1 and Form BDW; ICR Reference No. 202005–3235–003; OMB Control No. 3235–0018 (May 5, 2020), available at [https://www.reginfo.gov/public/do/PRAViewDocument?ref\\_nbr=202005-3235-003](https://www.reginfo.gov/public/do/PRAViewDocument?ref_nbr=202005-3235-003) (“Form BDW Supporting Statement”).

<sup>321</sup> One respondent multiplied by 1 hour per respondent.

<sup>322</sup> Form BDW Supporting Statement at 5.

<sup>323</sup> One respondent multiplied by (1 hour per respondent multiplied by \$536 per hour).

<sup>324</sup> Form BDW Supporting Statement at 5.

<sup>325</sup> See Extension without change of a currently approved collection: Rule 15c2–7, Identification of Quotations (17 CFR 240.15c2–7); ICR Reference No.

such notices could be made, the Commission estimates that one filing, in the aggregate, by only one broker-dealer, is made annually pursuant to Rule 15c2-7.<sup>326</sup> Based on prior industry estimates, the time required to enter a notice pursuant to Rule 15c2-7 is 45 seconds, or .75 minutes.<sup>327</sup> The Commission believes that there will not be any respondents that are required to register as a result of the Proposed Rules that must file a Rule 15c2-7 notice as a result of the Proposed Rules. Accordingly, the Commission estimates that there will be no internal compliance cost associated with the burden hours for Rule 15c2-7.

#### 4. Burden of Rule 15c3-1

Some of the respondents that would register with the Commission as a result of the Proposed Rules would likely incur a collection of information burden to comply with Rule 15c3-1. The Commission estimates the hour burdens of the requirements associated with Rule 15c3-1 as follows.

**Notices:** Based on the number of notices filed under Rule 15c3-1 in 2019, the Commission estimates that broker-dealers annually file approximately 844 notices under Rule 15c3-1 and that a broker-dealer will spend approximately 30 minutes preparing and filing these notices.<sup>328</sup> The Commission estimates that at least approximately 23 of the 97 respondents would likely each file one notice under Rule 15c3-1, for a total of 23 notices.<sup>329</sup> Accordingly the Commission estimates a total additional annual burden of approximately 11.5 hours.<sup>330</sup>

**Capital Withdrawal Liability:** Paragraph (c)(2)(i)(G)(2) of Rule 15c3-1 requires that a broker-dealer treat as a

202008-3235-005; OMB Control No: 3235-0479 (Sep. 16, 2020), available at [https://www.reginfo.gov/public/do/PRAViewDocument?ref\\_nbr=202008-3235-005](https://www.reginfo.gov/public/do/PRAViewDocument?ref_nbr=202008-3235-005) ("Rule 15c2-7 PRA Supporting Statement").

<sup>326</sup> Rule 15c2-7 PRA Supporting Statement at 3.

<sup>327</sup> *Id.*

<sup>328</sup> Extension Without Change of a Currently Approved Collection; Rule 15c3-1: Net Capital Requirements for Brokers and Dealers; ICR Reference No: 201912-3235-005; OMB Control No: 3235-0200 (Jan. 16, 2020), available at [https://www.reginfo.gov/public/do/PRAViewDocument?ref\\_nbr=201912-3235-005](https://www.reginfo.gov/public/do/PRAViewDocument?ref_nbr=201912-3235-005) ("Rule 15c3-1 PRA Supporting Statement").

<sup>329</sup> The Commission estimated that as of June 2019 broker-dealers submitted approximately 844 notices annually. Rule 15c3-1 PRA Supporting Statement at 4. The number of active broker-dealers on June 30, 2019 was 3,710. Thus, approximately 23 percent of the active broker-dealers submitted a notice annually as of June 2019. Based on this, the Commission estimates that the 97 respondents that would need to register with the Commission under the Proposed Rules would file approximately 23 notices annually.

<sup>330</sup> 23 respondents multiplied by .5 hours per respondent.

liability any capital contribution that is intended to be withdrawn within one year of its contribution. The amendment also includes the presumption that capital withdrawn within one year of contribution is presumed to have been intended to be withdrawn within one year, unless the broker-dealer receives permission in writing for the withdrawal from its DEA. The Commission estimates it will take a broker-dealer approximately one hour to prepare and submit the request to its DEA to withdraw capital,<sup>331</sup> and that at least approximately two respondents would likely seek permission in writing one occasion for the capital withdrawal.<sup>332</sup> Accordingly, the Commission estimates that the total annual reporting burden will be approximately two hours.<sup>333</sup>

Some broker-dealers that file consolidated financial reports obtain an opinion of counsel under appendix C of Rule 15c3-1.<sup>334</sup> The Commission believes that there will not be any respondents that are required to register as a result of the Proposed Rules that will obtain an opinion of counsel to file the consolidated financial reports as required under appendix C of Rule 15c3-1. It is not anticipated that respondents will have to incur any capital and start-up costs, nor any additional operational or maintenance costs, to comply with the collection of information.

#### 5. Burden of Rule 15c3-5

To comply with Rule 15c3-5, a respondent must maintain its risk management system by monitoring its effectiveness and updating its systems to address any issues detected.<sup>335</sup> In addition, a respondent is required to preserve a copy of its written description of its risk management controls as part of its books and records in a manner consistent with Rule 17a-4(e)(7) under the Exchange Act.<sup>336</sup> The Commission estimates that the ongoing annualized burden for a respondent to maintain its risk management system will be approximately 115 burden

<sup>331</sup> Rule 15c3-1 PRA Supporting Statement at 5.

<sup>332</sup> The Commission estimated that as of June 2019 broker-dealers submitted approximately 84 notices annually. Rule 15c3-1 PRA Supporting Statement at 5. The number of active broker-dealers on June 30, 2019 was 3,710. Thus, approximately .02 percent of the active broker-dealers submitted a notice annually as of June 2019. Based on this, the Commission estimates that the 97 respondents that would need to register with the Commission under the Proposed Rules would file approximately two notices annually.

<sup>333</sup> Two respondents multiplied by 1 hour per respondent.

<sup>334</sup> Rule 15c3-1 PRA Supporting Statement at 11.

<sup>335</sup> See 17 CFR 240.15c3-5.

<sup>336</sup> *Id.*

hours.<sup>337</sup> The Commission estimates the related internal compliance cost for this hour burden per respondent at approximately \$31,717 per year.<sup>338</sup> The Commission believes the ongoing burden of complying with the rule's collection of information will include, among other things, updating systems to address any issues detected, updating risk management controls to reflect any change in its business model, and documenting and preserving a broker-dealer's written description of its risk management controls.<sup>339</sup> In addition, the Commission estimates that a broker-dealer's legal and compliance burden of complying with Rule 15c3-5 will require approximately 45 hours per year.<sup>340</sup> The Commission estimates the related internal compliance cost for this hour burden per respondent at approximately \$25,645 per year.<sup>341</sup>

Accordingly, the Commission estimates the annual aggregate information burden per respondent would be 160 hours,<sup>342</sup> for a total annual burden of 15,520 hours.<sup>343</sup> The Commission estimates the related total internal compliance cost for the respondents required to register as a result of the Proposed Rules for this hour burden at approximately \$5,564,114 per year.<sup>344</sup> In addition, the Commission estimates that for hardware and software expenses, the average ongoing external cost would be approximately \$20,500 per respondent,<sup>345</sup> for a total annualized external cost for all respondents of \$1,988,500.<sup>346</sup>

#### 6. Burden of Rule 17a-3

As discussed above, the respondents that would register as dealers or

<sup>337</sup> See Extension Without Change of a Currently Approved Collection: Rule 15c3-5—Risk Management Controls for Brokers or Dealers with Market Access; ICR Reference No: 201907-3235-022; OMB Control No: 3235-0673 (July 23, 2019) available at [https://www.reginfo.gov/public/do/PRAViewDocument?ref\\_nbr=201907-3235-022](https://www.reginfo.gov/public/do/PRAViewDocument?ref_nbr=201907-3235-022) ("Rule 15c3-5 Supporting Statement").

<sup>338</sup> Rule 15c3-5 Supporting Statement at 4.

<sup>339</sup> *Id.*

<sup>340</sup> *Id.* at 5. Specifically, compliance attorneys who review, document, and update written compliance policies and procedures are expected to require an estimated 20 hours per year; a compliance manager who reviews, documents, and updates written compliance policies and procedures is expected to require 20 hours per year; and the Chief Executive Officer, who certifies the policies and procedures, is expected to require another 5 hours per year. *Id.*

<sup>341</sup> *Id.*

<sup>342</sup> 115 hours for technology + 45 hours for legal and compliance.

<sup>343</sup> 97 respondents multiplied by 160 hours.

<sup>344</sup> 97 respondents multiplied by (\$31,717 for technology + \$25,645 for legal and compliance).

<sup>345</sup> Rule 15c3-5 Supporting Statement at 6.

<sup>346</sup> 97 respondents multiplied by \$20,500 per respondent.

government securities as a result of the Proposed Rules would incur a burden of collection of information necessary to comply with Rule 17a-3. While recordkeeping requirements will vary based on the size and complexity of the broker-dealer, the Commission estimates that one hour a day<sup>347</sup> is the average amount of time needed by a broker-dealer to comply with the overall requirements of Rule 17a-3, in addition to the separate burdens described below. The number of working days per year is 249, and as a result the total annual estimated burden for respondents with respect to Rule 17a-3 generally is 24,153 hours.<sup>348</sup>

(i) Rule 17a-3(a)(12) and (19)

In addition to the hour burden estimate for Rule 17a-3 generally, the Commission also believes that paragraphs (a)(12) and (19) of Rule 17a-3 will impose specific burdens on respondents. Paragraphs (a)(12) and (19) of Rule 17a-3 require that a broker-dealer create certain records regarding its associated persons.<sup>349</sup> The Commission estimates that each broker-dealer spends, on average, approximately 30 minutes each year<sup>350</sup> to ensure that it is in compliance with these requirements, resulting in a total annual compliance burden of approximately 48.5 hours for the respondents.<sup>351</sup>

(ii) Rule 17a-3(a)(20) Through (22)

Paragraphs (a)(20) through (22) of Rule 17a-3 require broker-dealers to make, among other things, records documenting the broker-dealer's compliance, or that the broker-dealer has adopted policies and procedures reasonably designed to establish compliance, with applicable Federal

<sup>347</sup> See Revision of a Currently Approved Collection: Rule 17a-3; Records to be Made by Certain Exchange Members, Brokers and Dealers; ICR Reference No: 202107-3235-019; OMB Control No: 3235-0033 (July 29, 2021), available at [https://www.reginfo.gov/public/do/PRAViewDocument?ref\\_nbr=202107-3235-019](https://www.reginfo.gov/public/do/PRAViewDocument?ref_nbr=202107-3235-019) ("Rule 17a-3 PRA Supporting Statement").

<sup>348</sup> 97 respondents multiplied by 249 hours per respondent a year.

<sup>349</sup> These records that a broker-dealer is required to make regarding the broker-dealer's associated persons include: (1) All agreements pertaining to the associated person's relationship with the broker-dealer and a summary of each associated person's compensation arrangement (17 CFR 240.17a-3(a)(19)(ii)), (2) a record delineating all identification numbers relating to each associated person (17 CFR 240.17a-3(a)(12)(ii)), (3) a record of the office at which each associated person regularly conducts business (17 CFR 240.17a-3(a)(12)(iii)), and (4) a record as to each associated person listing transactions for which that person will be compensated (17 CFR 240.17a3(a)(19)(i)).

<sup>350</sup> Rule 17a-3 PRA Supporting Statement at 6.

<sup>351</sup> 97 respondents multiplied by .5 hours per respondent.

regulations and SRO rules that require approval by a principal of the broker-dealer of any advertisements, sales literature or other communications with the public.<sup>352</sup> Moreover, these rules require broker-dealers to create a record of the personnel responsible for establishing compliance policies and procedures and of the personnel capable of explaining the types of records the broker-dealer.<sup>353</sup> The Commission estimates that, on average, each broker-dealer will spend 10 minutes each year<sup>354</sup> to ensure compliance with these requirements, resulting in a total annual burden for the respondents of about approximately 16 hours.<sup>355</sup>

7. Burden of Rule 17a-4

The respondents that registered as dealers or government securities would incur a collection of information burden to comply with Rule 17a-4. Rule 17a-4 establishes the records that must be preserved by broker-dealers.<sup>356</sup> The Commission estimates that, on average, each broker-dealer spends 254 hours each year<sup>357</sup> to ensure that it preserves the records Rule 17a-4 requires all broker-dealers to preserve. Accordingly, the Commission estimates that there will be a total annual burden of 24,638 hours to comply with the Rule 17a-4 requirements applicable to the respondents.<sup>358</sup> The Commission estimates that the average broker-dealer spends approximately \$5,000 each year to store documents required to be retained under Rule 17a-4.<sup>359</sup> Accordingly, the Commission estimates the annual reporting and recordkeeping cost burden for the respondents to be \$485,000.<sup>360</sup>

<sup>352</sup> See 17 CFR 240.17a-3(a)(20); 17 CFR 240.17a-3(a)(21); 17 CFR 240.17a-3(a)(22).

<sup>353</sup> *Id.*

<sup>354</sup> Rule 17a-3 PRA Supporting Statement at 6.

<sup>355</sup> (97 respondents multiplied by 10 minutes per respondent) divided by 60 minutes.

<sup>356</sup> See 17 CFR 240.17a-4.

<sup>357</sup> See Revision of a currently approved collection: Rule 17a-4; Records to be Preserved by Certain Exchange Members, Brokers and Dealers; ICR Reference No: 202107-3235-021; OMB Control No: 3235-0279 (Sep. 23, 2021), available at [https://www.reginfo.gov/public/do/PRAViewDocument?ref\\_nbr=202107-3235-021](https://www.reginfo.gov/public/do/PRAViewDocument?ref_nbr=202107-3235-021) ("Rule 17a-4 Supporting Statement").

<sup>358</sup> 97 respondents multiplied by 254 hours per respondent.

<sup>359</sup> Rule 17a-4 Supporting Statement at 13. Costs include the cost of physical space, computer hardware and software, etc., which vary widely depending on the size of the broker-dealer and the type of storage media employed. *Id.*

<sup>360</sup> 97 respondents multiplied by \$5,000 per respondent.

8. Burden of Rule 17a-5<sup>361</sup>

This section summarizes the burdens associated with Rule 17a-5.

*FOCUS Report for Broker-Dealers that do not Clear Transactions or Carry Customer Accounts:* Rule 17a-5(a)(2)(iii) requires that broker-dealers that do not clear transactions or carry customer accounts and do not use ANC models to calculate net capital are required to file FOCUS Report Part IIA on a quarterly basis.<sup>362</sup> The Commission believes that the 97 respondents that would be required to register with the Commission would need to comply with this provision of Rule 17a-5. The Commission estimates that each FOCUS Report Part IIA takes approximately 12 hours to prepare and file.<sup>363</sup> As a result, each respondent is estimated to have an annual reporting burden of 48 hours,<sup>364</sup> resulting in an annual burden of 4,656 hours.<sup>365</sup>

*Annual Reports:* Rule 17a-5(d)(1)(i)(A) requires broker-dealers, subject to limited exception, to file annual reports, including financial statements and supporting schedules that generally must be audited by a PCAOB-registered independent public accountant in accordance with PCAOB standards. The Commission believes that the 97 respondents that would be required to register with the Commission would be need to file an annual report. The Commission estimates that each respondent is estimated to have an annual reporting burden of 12 hours under Rule 17a-5(d),<sup>366</sup> resulting in an annual burden of 1,164 hours for the respondents.<sup>367</sup>

*Exemption Report:* Rule 17a-5(d)(1)(i)(B) requires a broker-dealer that claims it was exempt from 17 CFR 240.15c3-3 (Rule 15c3-3) throughout the most recent fiscal year must file an exemption report with the Commission on an annual basis.<sup>368</sup> As of December 31, 2019, 3,689 broker-dealers filed FOCUS Reports with the Commission and, of these, 3,001 broker-dealers

<sup>361</sup> Registered government securities dealers are required to comply with Rule 17a-11, subject to the enumerated modifications in 17 U.S.C. 405.3. See 17 U.S.C. 405.3.

<sup>362</sup> See 17 CFR 240.17a-5(a)(2)(iii).

<sup>363</sup> See Revision of a Currently Approved Collection: Rule 17a-5, Form X-17a-5 (FOCUS REPORT); ICR Reference No: 202107-3235-022; OMB Control No: 3235-0123 (July 29, 2021), available at [https://www.reginfo.gov/public/do/PRAViewDocument?ref\\_nbr=202107-3235-022](https://www.reginfo.gov/public/do/PRAViewDocument?ref_nbr=202107-3235-022) ("Rule 17a-5 PRA Supporting Statement").

<sup>364</sup> Rule 17a-5 PRA Supporting Statement at 6.  
<sup>365</sup> 97 respondents multiplied by 48 hours per respondent.

<sup>366</sup> Rule 17a-5 PRA Supporting Statement at 7.

<sup>367</sup> 97 respondents multiplied by 12 hours per respondent.

<sup>368</sup> See 17 CFR 240.17a-5(d)(1)(i)(B).

claimed exemptions from Rule 15c3–3.<sup>369</sup> The Commission estimates that it takes a broker-dealer claiming an exemption from Rule 15c3–3 approximately 7 hours to complete the exemption report.<sup>370</sup> The Commission also estimates that approximately 78 of the 97 respondents<sup>371</sup> would also claim exemptions from Rule 15c3–3 and be required to file an exemption report, resulting in an annual burden of 546 hours.<sup>372</sup>

*SIPC Annual Reports:* Paragraph (d)(6) of Rule 17a–5 requires a Securities Investor Protection Corporation (“SIPC”) member broker-dealers to file a copy of the annual reports with SIPC.<sup>373</sup> The Commission estimates that it takes a broker-dealer approximately 30 minutes to file the annual reports with SIPC.<sup>374</sup> As a result, each firm is estimated to have an annual burden of .5 hour, resulting in an annual burden of 48.5 hours for the respondents.<sup>375</sup>

*SIPC Annual General Assessment Reconciliation Report or Exclusion from Membership Forms:* Paragraph (e)(4) of Rule 17a–5 requires broker-dealers to file with SIPC a report on the SIPC annual general assessment reconciliation or exclusion from membership forms.<sup>376</sup> The Commission estimates that it takes a broker-dealer approximately 5 hours to file SIPC’s annual assessment reconciliation form or certification of exclusion from membership forms,<sup>377</sup> resulting in an estimated annual burden of about 485 hours for the respondents.<sup>378</sup>

*Statement Regarding Independent Public Accountant:* Paragraph (f)(2) of Rule 17a–5 requires broker-dealers to prepare a statement providing information regarding the broker-dealer’s independent public accountant and to file it each year with the Commission and its DEA (except that if the engagement is of a continuing nature, no further filing is required).<sup>379</sup>

<sup>369</sup> Rule 17a–5 PRA Supporting Statement at 8.

<sup>370</sup> *Id.*

<sup>371</sup> The Commission believes that the same percentage of broker-dealers that claimed exemptions from Rule 15c3–3 as of December 31, 2019 applies to the 97 respondents that would register with the Commission as a result of the Proposed Rules. Accordingly, the Commission estimates that 80 percent of the 97 respondents would file an exemption report under Rule 17a–5(d)(1)(i)(A).

<sup>372</sup> 78 respondents multiplied by 7 hours per respondent.

<sup>373</sup> See 17 CFR 240.17a–5(d)(6).

<sup>374</sup> Rule 17a–5 PRA Supporting Statement at 8.

<sup>375</sup> 97 respondents multiplied by .5 hour per respondent.

<sup>376</sup> See 17 CFR 240.17a–5(e)(4).

<sup>377</sup> Rule 17a–5 PRA Supporting Statement at 9.

<sup>378</sup> 97 respondents multiplied by 5 hours per respondent.

<sup>379</sup> 17 CFR 240.17a–5(f)(2).

The Commission estimates that it takes a broker-dealer that neither carries customer accounts nor clears transactions approximately 2 hours to file the Statement Regarding Independent Public Accountant with the Commission.<sup>380</sup> As a result, each broker-dealer that neither carries nor clears transactions is estimated to have an annual burden of 2 hours, resulting in an annual burden of 194 hours for the respondents.<sup>381</sup>

The Commission estimates that Rule 17a–5 causes a broker-dealer to incur an annual dollar cost to meet its reporting obligations. Those requirements that are anticipated to impose an annual cost are discussed below.

*Annual Reports:* The Commission estimates that postage costs to comply with paragraph (d) of Rule 17a–5 impose on broker-dealers an annual dollar cost of \$7.75 per firm,<sup>382</sup> resulting in a total annual cost for the respondents of approximately \$751.75.<sup>383</sup>

*Exemption Report:* A broker-dealer that claims it was exempt from Rule 15c3–3 throughout the most recent fiscal year must file an exemption report with the Commission on an annual basis.<sup>384</sup> The cost associated with an independent public accountant’s review of the exemption report is estimated to create an ongoing cost of \$3,000 per non-carrying broker-dealer per year,<sup>385</sup> for a total annual reporting cost of approximately \$234,000.<sup>386</sup>

*SIPC Annual Reports:* The Commission estimates that postage costs to comply with paragraph (d)(6) of Rule 17a–5 impose an annual dollar cost of 50 cents per firm registered with SIPC as a SIPC member broker-dealer,<sup>387</sup> totaling for the 97 respondents an estimated cost burden for the response of \$48.50.<sup>388</sup>

*SIPC Annual General Assessment Reconciliation Report or Exclusion from Membership Forms:* The Commission estimates that postage costs to comply with paragraph (e)(4) of Rule 17a–5, impose an annual dollar cost of 50 cents

<sup>380</sup> Rule 17a–5 PRA Supporting Statement at 9.

<sup>381</sup> 97 respondents multiplied by 2 hours per respondent.

<sup>382</sup> Rule 17a–5 PRA Supporting Statement at 15.

<sup>383</sup> 97 respondents multiplied by \$7.75 per respondent.

<sup>384</sup> See 17 CFR 240.17a–5(d)(1)(i)(B).

<sup>385</sup> Rule 17a–5 PRA Supporting Statement at 16.

<sup>386</sup> 78 respondents multiplied by \$3,000 per respondent. As discussed above, the Commission also estimates that approximately 78 of the 97 respondents would also claim exemptions from Rule 15c3–3.

<sup>387</sup> Rule 17a–5 PRA Supporting Statement at 16.

<sup>388</sup> 97 respondents multiplied by \$0.50 per respondent.

per firm.<sup>389</sup> The Commission estimates that each year the 97 respondents will file with SIPC a report on the SIPC annual general assessment reconciliation or exclusion from membership forms, such that the estimated cost burden totals \$48.50 per year.<sup>390</sup>

*Statement Regarding Independent Public Accountant:* The Commission estimates that postage costs to comply with paragraphs (f)(2) and (3) of Rule 17a–5, impose an annual dollar cost of 50 cents per firm.<sup>391</sup> Accordingly, the Commission estimates a total cost of \$48.50 per year for the 97 respondents.<sup>392</sup>

#### 9. Burden of Rule 17a–11

In 2019, the Commission received 343 Rule 17a–11 notices from broker-dealers.<sup>393</sup> The Commission previously estimated that it would receive a similar number of notices from broker-dealers each year over the next three years and that it will take approximately one hour to prepare and transmit each notice.<sup>394</sup> The Commission believes that the Proposed Rules would not cause any change to the Commission’s estimated number of 17a–11 notices received from broker-dealers.

#### 10. Burden of Rule 613

Rule 613(c) provides that certain requirements are placed upon broker-dealers to record and report CAT information to the central repository in accordance with specified timelines.<sup>395</sup> The Commission recognizes that broker-dealers may insource or outsource CAT data reporting obligations.<sup>396</sup> The Commission believes all 97 respondents would likely have reporting obligations under Rule 613 and strategically decide to insource their data reporting functions as a result of their high level

<sup>389</sup> Rule 17a–5 PRA Supporting Statement at 16.

<sup>390</sup> 97 respondents multiplied by \$0.50 per respondent.

<sup>391</sup> Rule 17a–5 PRA Supporting Statement at 17.

<sup>392</sup> 97 respondents multiplied by \$0.50 per respondent.

<sup>393</sup> Revision of a Currently Approved Collection: Rule 17a–11 (17 CFR 240.17a–11) Notification provisions for Brokers and Dealers; ICR Reference No: 202107–3235–023; OMB Control No: 3235–0085 (Sep. 14, 2021), available at [https://www.reginfo.gov/public/do/PRAViewDocument?ref\\_nbr=202107-3235-023](https://www.reginfo.gov/public/do/PRAViewDocument?ref_nbr=202107-3235-023) (“17a–11 PRA Supporting Statement”).

<sup>394</sup> 17a–11 PRA Supporting Statement at 4.

<sup>395</sup> 17 CFR 242.613(c).

<sup>396</sup> Revision of a currently approved collection: Consolidated Audit Trail NMS Plan (NMS Plan Required to be Filed under Commission Rule 613); ICR Reference No: 201911–3235–003; OMB Control No: 3235–0671 (Apr. 1, 2020), available at [https://www.reginfo.gov/public/do/PRAViewDocument?ref\\_nbr=201911-3235-003](https://www.reginfo.gov/public/do/PRAViewDocument?ref_nbr=201911-3235-003) (“CAT Supporting Statement”).

of trading activity.<sup>397</sup> The Commission estimates that the average initial burden associated with implementing regulatory data reporting to capture the required information and transmit it to the central repository in compliance with Rule 613 for each respondent to be approximately 14,490 initial burden hours,<sup>398</sup> totaling an initial burden of 1,405,530 hours for the respondents.<sup>399</sup> After a respondent establishes the appropriate systems and processes required for collection and transmission of the required information, the Commission estimates that Rule 613 imposes ongoing annual burdens associated with, among other things, personnel time to monitor each respondent's reporting of the required data and the maintenance of the systems to report the required data; and implementing changes to trading systems that might result in additional reports.<sup>400</sup> The Commission believes that it would take each respondent approximately 13,338 burden hours per year<sup>401</sup> to continue to comply with Rule 613, totaling an annual ongoing burden of 1,293,786 hours for the respondents.<sup>402</sup>

Additionally, the Commission estimates that each respondent, on average, incurs approximately \$450,000 in initial costs for hardware and software to implement the systems changes needed to capture the required information and transmit it to the central repository, an additional \$9,500 in initial third party costs, and an additional \$250,000 in costs to implement the modified allocation timestamp requirement,<sup>403</sup> totaling an initial cost of \$68,821,500 for the respondents.<sup>404</sup> After each respondent has established the appropriate systems and processes, the Commission believes that Rule 613 imposes ongoing annual burdens associated with, among other things, personnel time to monitor each respondent's reporting of the required data and the maintenance of the systems to report the required data; and implementing changes to trading systems that might result in additional reports to the central repository.<sup>405</sup> The Commission estimates costs for each

respondent, on average, of approximately \$80,000 per year to maintain systems connectivity to the central repository and purchase any necessary hardware, software, and other materials, an additional \$1,300 per year in third party costs, and an additional \$29,166.67 per year to maintain the modified allocation timestamp requirement,<sup>406</sup> totaling an estimated annual ongoing cost of \$10,715,268 for the respondents.<sup>407</sup>

#### E. Request for Comments

Pursuant to 44 U.S.C. 3506(c)(2)(B), the Commission solicits comments to:

79. Evaluate whether the proposed collection of information is necessary for the proper performance of the Commission's functions, including whether the information shall have practical utility;

80. Evaluate whether the Commission is adequately capturing the number of respondents that would be subject to the burdens under the Proposed Rules;

81. Evaluate the accuracy of the Commission's estimates of the burden of the proposed collection of information;

82. Evaluate the accuracy of the Commission's estimates of the costs associated with the proposed collection of information, including but not limited to any start-up, technology, personnel, legal services, operational, or maintenance costs, to comply with the collection of information;

83. Evaluate whether the Proposed Rules would have any effects on any other collection of information not previously identified in this section; and

84. Determine whether any aspects of the Proposed Rules that are not discussed in this PRA analysis impact the burden or costs associated with the collection of information.

Persons submitting comments on the collection of information requirements should direct them to the Office of Management and Budget, Attention: Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Washington, DC 20503, and should also send a copy of their comments to Vanessa Countryman, Secretary, Securities and Exchange Commission, 100 F Street NE, Washington, DC 20549-1090, with reference to File Number S7-12-22. Requests for materials submitted to OMB by the Commission with regard to this

<sup>406</sup> *Id.*

<sup>407</sup> 97 respondents multiplied by ((\$80,000 in external hardware and software costs) + (\$29,166.67 to maintain the modified allocation timestamp requirement) + (\$1,300 ongoing external third party/outsourcing costs) = \$110,466.68).

collection of information should be in writing, with reference to File Number S7-12-22 and be submitted to the Securities and Exchange Commission, Office of FOIA/PA Services, 100 F Street NE, Washington, DC 20549-2736. As OMB is required to make a decision concerning the collection of information between 30 and 60 days after publication, a comment to OMB is best assured of having its full effect if OMB receives it within 30 days of publication.

#### VII. Regulatory Flexibility Certification

The Regulatory Flexibility Act ("RFA") requires Federal agencies, in promulgating rules, to consider the impact of those rules on small entities. Section 603(a) of the Administrative Procedure Act,<sup>408</sup> as amended by the RFA, generally requires the Commission to undertake a regulatory flexibility analysis of all proposed rules, or proposed rule amendments, to determine the impact of the rulemaking on "small entities."<sup>409</sup> Section 605(b) of the RFA<sup>410</sup> states that this requirement shall not apply to any proposed rule or proposed rule amendment which, if adopted, would not have a significant economic impact on a substantial number of small entities.<sup>411</sup>

The RFA defines "small entity" to mean "small business," "small organization," or "small governmental jurisdiction."<sup>412</sup> The Commission's rules define "small business" and "small organization" for purpose of the RFA for each of the types of entities regulated by the Commission.<sup>413</sup> A "small business" and "small organization," when used in reference to a person other than an investment company, generally means a person with total assets of \$5 million or less on the last day of its most recent fiscal year.<sup>414</sup>

The Proposed Rules would not apply to persons that have or control total assets of less than \$50 million.<sup>415</sup>

<sup>408</sup> 5 U.S.C. 603(a).

<sup>409</sup> Although Section 601(b) of the RFA defines the term "small entity," the statute permits agencies to formulate their own definitions. The Commission has adopted definitions for the term "small entity" for the purposes of Commission rulemaking in accordance with the RFA. Those definitions, as relevant to this proposed rulemaking, are set forth in 17 CFR 240.0-10 (Rule 0-10 under the Exchange Act). See also Exchange Act Release No. 18451 (Jan. 28, 1982), 47 FR 5215 (Feb. 4, 1982) (File No. AS-305).

<sup>410</sup> 5 U.S.C. 605(b).

<sup>411</sup> 5 U.S.C. 605(b).

<sup>412</sup> 5 U.S.C. 601(6).

<sup>413</sup> Exchange Act Rule 0-10 (17 CFR 240.0-10) contains applicable definitions.

<sup>414</sup> *Id.*

<sup>415</sup> See proposed Rule 3a5-4(a)(2)(i) and proposed Rule 3a44-2(a)(3)(i). See also Section V.B.2.c.

<sup>397</sup> See CAT Supporting Statement at 37.

<sup>398</sup> *Id.* at 39.

<sup>399</sup> 97 respondents multiplied by 14,490 hours.

<sup>400</sup> See CAT Supporting Statement at 39-40.

<sup>401</sup> *Id.* at 40.

<sup>402</sup> 97 respondents multiplied by 13,338 hours.

<sup>403</sup> See CAT Supporting Statement at 63-64.

<sup>404</sup> 97 respondents multiplied by ((\$450,000 in external hardware and software costs) + (\$250,000 to implement the modified allocation timestamp requirement) + (\$9,500 initial third party/outsourcing costs) = \$709,500).

<sup>405</sup> See CAT Supporting Statement at 66.

Therefore, because small businesses and small organizations with total assets of \$5 million or less would not meet the requirements of the Proposed Rules, the Commission believes the Proposed Rules would not, if adopted, have a significant economic impact on a substantial number of small entities.

For the foregoing reasons, the Commission certifies, pursuant to 5 U.S.C. 605(b), that the Proposed Rules, if adopted, would not have a significant economic impact on a substantial number of small entities for purposes of the RFA. The Commission encourages written comments regarding this certification. Specifically, the Commission solicits comment as to whether the proposed Rules 3a5-4 and 3a44-2 could have an effect on small entities that has not been considered. We request that commenters describe the nature of any impact on small entities and provide empirical data to support the extent of such impact. These comments will be considered in the preparation of the Final Regulatory Flexibility Certification, if the Proposed Rules are adopted, and will be placed in the same public file as comments on the Proposed Rules. Persons wishing to submit written comments should refer to the instructions for submitting comments in the front of this release.

### VIII. Consideration of Impact on the Economy

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996,<sup>416</sup> the Commission requests comment on the potential effect of the Proposed Rules on the United States economy on an annual basis. The Commission also requests comment on any potential increases in costs or prices for consumers or individual industries, and any potential effect on competition, investment, or innovation.

#### Statutory Basis and Text of the Proposed Rules

The Commission is proposing Rules 3a5-4 and 3a44-2 pursuant to authority set forth in Sections 3 and 23 of the Exchange Act (15 U.S.C. 78c and 78w).

#### Text of Proposed Rule

##### List of Subjects in 17 CFR Part 240

Government securities dealers,  
Securities dealers.

For the reasons set out in the preamble, the Commission proposes to amend title 17, chapter II, of the Code of Federal Regulations as follows:

### PART 240—GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

■ 1. The authority citation for part 240 continues to read, in part, as follows:

**Authority:** 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z-2, 77z-3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78c-3, 78c-5, 78d, 78e, 78f, 78g, 78i, 78j, 78j-1, 78k, 78k-1, 78l, 78m, 78n, 78n-1, 78o, 78o-4, 78o-10, 78p, 78q, 78q-1, 78s, 78u-5, 78w, 78x, 78dd, 78ll, 78mm, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4, 80b-11, and 7201 *et seq.*, and 8302; 7 U.S.C. 2(c)(2)(E); 12 U.S.C. 5221(e)(3); 18 U.S.C. 1350; Pub. L. 111-203, 939A, 124 Stat. 1376 (2010); and Pub. L. 112-106, sec. 503 and 602, 126 Stat. 326 (2012), unless otherwise noted.

\* \* \* \* \*

■ 2. Add § 240.3a5-4 to read as follows:

#### § 240.3a5-4 Further definition of “as a part of a regular business”.

(a) A person that is engaged in buying and selling securities for its own account is engaged in such activity “as a part of a regular business” as the phrase is used in Section 3(a)(5)(B) (15 U.S.C. 78c(a)(5)(B)) of the Act if that person:

(1) 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; and

(2) Is not:

(i) A person that has or controls total assets of less than \$50 million; or

(ii) An investment company registered under the Investment Company Act of 1940.

(b) For purposes of this section:

(1) The term “person” has the same meaning as prescribed in Section 3(a)(9) (15 U.S.C. 78c(a)(9)) of the Act.

(2) A person’s “own account” means any account:

(i) Held in the name of that person; or

(ii) Held in the name of a person over whom that person exercises control or with whom that person is under common control, provided that this paragraph (b)(2)(ii) does not include:

(A) An account in the name of a registered broker, dealer, or government securities dealer, or an investment company registered under the Investment Company Act of 1940; or

(B) With respect to an investment adviser registered under the Investment Advisers Act of 1940, an account held in the name of a client of the adviser unless the adviser controls the client as a result of the adviser’s right to vote or direct the vote of voting securities of the client, the adviser’s right to sell or direct the sale of voting securities of the client, or the adviser’s capital contributions to or rights to amounts upon dissolution of the client; or

(C) With respect to any person, an account in the name of another person that is under common control with that person solely because both persons are clients of an investment adviser registered under the Investment Advisers Act of 1940 unless those accounts constitute a parallel account structure; or

(iii) Held for the benefit of those persons identified in paragraphs (b)(2)(i) and (ii) of this section.

(3) The term “control” has the same meaning as prescribed in § 240.13h-1 (Rule 13h-1), under the Act.

(4) The term “parallel account structure” means a structure in which one or more private funds (each a “parallel fund”), accounts, or other pools of assets (each a “parallel managed account”) managed by the same investment adviser pursue substantially the same investment objective and strategy and invest side by side in substantially the same positions as another parallel fund or parallel managed account.

(c) No presumption shall arise that a person is not a dealer within the meaning of Section 3(a)(5) (15 U.S.C. 78c(a)(5)) of the Act solely because that person does not satisfy paragraph (a) of this section.

■ 3. Add § 240.3a44-2 to read as follows:

#### § 240.3a44-2 Further definition of “as a part of a regular business”.

(a) A person that is engaged in buying and selling government securities for its own account is engaged in such activity “as a part of a regular business” as the phrase is used in Section 3(a)(44)(A) (15 U.S.C. 78c(a)(44)(A)) of the Act if that person:

(1) Engages in a routine pattern of buying and selling government securities that has the effect of providing liquidity to other market participants by:

(i) Routinely making roughly comparable purchases and sales of the

<sup>416</sup> 5 U.S.C. 603.

same or substantially similar government securities in a day; or

(ii) Routinely expressing trading interests that are at or near the best available prices on both sides of the market and that are communicated and represented in a way that makes them accessible to other market participants; or

(iii) Earning revenue primarily from capturing bid-ask spreads, by buying at the bid and selling at the offer, or from capturing any incentives offered by trading venues to liquidity-supplying trading interests; or

(2) In each of four out of the last six calendar months, engaged in buying and selling more than \$25 billion of trading volume in government securities as defined in Section 3(a)(42)(A) (15 U.S.C. 78c(a)(42)(A)) of the Act; and

(3) Is not:

(i) A person that has or controls total assets of less than \$50 million; or

(ii) An investment company registered under the Investment Company Act of 1940.

(b) For purposes of this section:

(1) The term “person” has the same meaning as prescribed in Section 3(a)(9) (15 U.S.C. 78c(a)(9)) of the Act.

(2) A person’s “own account” means any account:

(i) Held in the name of that person; or

(ii) Held in the name of a person over whom that person exercises control or with whom that person is under common control, provided that this paragraph (b)(2)(ii) does not include:

(A) An account in the name of a registered broker, dealer, or government securities dealer, or an investment company registered under the Investment Company Act of 1940; or

(B) With respect to an investment adviser registered under the Investment Advisers Act of 1940, an account held in the name of a client of the adviser unless the adviser controls the client as a result of the adviser’s right to vote or direct the vote of voting securities of the client, the adviser’s right to sell or direct the sale of voting securities of the client, or the adviser’s capital contributions to or rights to amounts upon dissolution of the client; or

(C) With respect to any person, an account in the name of another person that is under common control with that person solely because both persons are clients of an investment adviser registered under the Investment Advisers Act of 1940 unless those accounts constitute a parallel account structure; or

(iii) Held for the benefit of those persons identified in paragraphs (b)(2)(i) and (ii) of this section.

(3) The term “control” has the same meaning as prescribed in § 240.13h-1 (Rule 13h-1), under the Act.

(4) The term “parallel account structure” means a structure in which one or more private funds (each a “parallel fund”), accounts, or other pools of assets (each a “parallel managed account”) managed by the same investment adviser pursue substantially the same investment objective and strategy and invest side by side in substantially the same positions as another parallel fund or parallel managed account.

(c) No presumption shall arise that a person is not a government securities dealer within the meaning of Section 3(a)(44) (15 U.S.C. 78c(a)(44)) of the Act solely because that person does not satisfy paragraph (a) of this section.

By the Commission.

Dated: March 28, 2022.

**J. Matthew DeLesDernier,**

*Assistant Secretary.*

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