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May 24, 2022

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

Re: File Number S7-12-22

Dear Ms. Countryman:

We represent certain professional equity trading firms,[1] which the Securities and Exchange Commission ("SEC" or "Commission") loosely characterized in a recently proposed dealer rule – Rule 3a5-4 under the Securities Exchange Act of 1934 ("Exchange Act") – as principal or proprietary trading firms (so-called "PTFs").[2] Proposed Rule 3a5-4 seeks to codify a definition of a "regular business" for purposes of applying the trader-dealer distinction under the Exchange Act.[3] As relevant to professional trading firms, the proposal excludes small market participants owning or controlling assets of less than $50 million.

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[1] These firms are closely held, private companies that trade equity securities using capital contributed by their owners. They establish no customer relationships, nor seek a regular clientele. Rather, they are the customers of large, full-service registered broker-dealers under prime brokerage arrangements ("Prime Brokers") that require these firms to, among other things, maintain minimum net equity of cash and marketable securities well in excess of the $500,000 minimum prescribed by the Prime Broker Letter, SEC No-Action Letter (pub. avail. Jan. 25, 1994) ("Prime Broker Letter").

[2] Securities Exchange Act Release No. 94524 (March 28, 2022), 87 F.R. 23054 (April 18, 2022) ("Proposing Release").

[3] The SEC proposed a companion rule codifying a regular government securities dealer business in proposed Rule 3a44-2. Our comments are focused on the proposals as they relate to equity markets and equity market participants, although the proposals' grouping of the Treasury and equity markets, as if they are the same, is flawed to the extent gaps in oversight of, and the unique market participation in, the Treasury market are used to justify regulating market participants in the equity markets, as if they are the same.

We appreciate the opportunity to comment on proposed Rule 3a5-4 and its stated purposes of enhancing transparency, stability, integrity, resiliency, and investor protection in the nation's securities markets via principles of functional dealer regulation.[4] We, however, do not believe an extension of the Exchange Act's dealer regulatory regime to capture professional equity trading firms, heretofore exempt as traders, will remedy the underlying concerns of market volatility that seem to be the impetus for the rule proposals. In other words, it is unlikely the imposition of an expanded dealer regulatory scheme, which is guaranteed to create an entire class of inadvertent dealers, will lead to less volatile or to more stable equity markets. Rather, this over-expansive application of regulation will most certainly raise costs, increase operational burdens, and drive many equity trading firms from the U.S. equity markets, thus leading to unintended adverse market impacts of decreased competition and degraded liquidity.[5]

By its own admission, the Commission conceded the proposed dealer regulations "will not by themselves necessarily prevent future market disruptions."[6] We agree. The nexus of registering and regulating exempt traders to the goal of enhanced transparency, stability, integrity, resiliency, and investor protection has not been persuasively made, particularly in light of existing regulatory authority (both exercised and unexercised) more appropriate to achieving a narrowly tailored means-to-an-end rulemaking. Conspicuously absent from the current discussion, at least with respect to the equity markets, are the large trader reporting program, enhanced equity trade reporting through the consolidated audit trail ("CATs Reporting"), risk management, such as prescribed in the Prime Broker Letter and by direct-market access protocols, and the Commission's currently undeployed rulemaking authority to address fraudulent market practices during periods of market volatility,[7] each of which more directly addresses issues of market structure.

Therefore, we encourage the Commission to withdraw or to not act on the dealer rule proposals in their current iteration to the extent they are premised on a treatment of the Treasury and equity markets, as if they are the same, and, with respect to the equity markets, to the extent the Commission has not considered and analyzed current regulatory programs and its other regulatory authority. That is, if the Commission believes remaining gaps in equity-market regulation exist, we respectfully recommend it refocus efforts on (i) evaluating existing regulations and unexercised regulatory authority authorized by the Market Reform Act of 1990 [Pub. L. 101-432, 104 Stat. 963 (October 16, 1990)] ("Market Reform Act") and (ii) explaining why the large trader reporting and CATs Reporting programs, among others, have been ineffective and, to the extent deemed ineffective, propose modifications to improve their effectiveness instead of adopting yet another set of new regulations aimed at apparently the same

[4] Proposing Release at 23056 and 23060.

[5] Academics argue that the advent of automation and the entry into the equity markets of high-frequency and algorithmic traders have significantly improved the equity markets by increasing liquidity and market depth, lowering retail commission costs, and narrowing bid-ask spreads. *See generally* Angel, James J., Harris, Lawrence E., and Spatt, Chester S., *Equity Trading in the 21st Century* (Feb. 23, 2010).

[6] Proposing Release at 23060.

[7] 15 U.S.C. §78i(i).

market-structure issues. We believe the use of existing regulatory tools more appropriately tailored to market-structure issues is a far superior regulatory alternative to the current proposals that the Commission itself admits will not fully achieve its stated goals.

I. THE TRADER EXCLUSION

A. Dealer-Trader Distinction Precedent

The Exchange Act registers and regulates dealers in securities.[8] Carved out from the Commission's broker-dealer regulatory regime are traders that, even though they buy and sell securities for their own accounts, do not do so as part of a "regular business."[9] Professional trading firms qualify for the trader exclusion in reliance on key interpretative positions developed over time to guide the meaning of a "regular business," which historically and predominantly equated a dealer business with, among other things, an intent to be a dealer (*i.e.*, holding out and/or advertising as a dealer) whose business is public-facing and includes the use of outside capital for trading purposes (*i.e.,* having a regular clientele).[10] In contrast to dealers, professional trading firms have no regular clientele (they have no customers). Nor do they seek a regular clientele or outside money, advertise their business, or interface directly with the public (all trading is through the systems and risk-management protocols of their Prime Brokers).

B. Proposed Codification of Liquidity Provider

The SEC now proposes to significantly modify these longstanding positions to capture professional trading firms by codifying three qualitative liquidity standards, which if triggered, effectively serve as a proxy for a *per se* regular dealer business.[11] (Government securities dealer

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[8] 15 U.S.C. §78o. The Exchange Act broadly defines a dealer generally as "any person engaged in the business of buying and selling securities . . . for such person's own account through a broker or otherwise." 15 U.S.C. §78c(a)(5)(A).

[9] 15 U.S.C. §78c(a)(5)(B).

[10] *See, e.g.,* 15 U.S.C. 78c(a)(38) (statutory text includes holding out as willing to buy and sell securities in market maker definition); Securities Exchange Release No. 63452 (Dec. 7, 2010), 75 F.R. 80174, 80178 (Dec. 21, 2010) ("both the 'security-based swap dealer' definition and the dealer-trader distinction in part turn on whether a person holds itself out as a dealer") ("Swaps Dealer Release"); and Securities Exchange Act Release No. 46745 (Oct. 30, 2002), 67 F.R. 67496, 67499 (Nov. 5, 2002) ("dealers normally have a regular clientele, hold themselves out to the public as buying or selling securities at a regular place of business, have a regular turnover (or participate in the distribution of new issues), and generally transact a substantial portion of their business with investors or, in the case of dealers who are market makers, principally trade with other professionals")). *See also Acqua Wellington North American Equities Fund, Ltd.,* SEC No-Action Letter (pub. avail. July 11, 2001) (setting forth multi-factor characteristics of a dealer); *Fairfield Trading Corp*, SEC No-Action Letter (pub. avail. Jan. 10, 1988); *Continental Grain Company*, SEC No-Action Letter (pub. avail. Nov. 6, 1987); *Louis Dreyfus Corporation*, SEC No-Action Letter (pub. avail. July 23, 1987); and *National Council of Savings Institutions*, SEC No-Action (pub. avail. July 27, 1986) (stating "[a]s a general matter, a trader does not handle other people's money or securities; he does not hold himself out as being willing to buy and sell securities for his own account on a continuous basis").

[11] The Proposing Release notes historical precedent is retained only insofar as it applies to market participants that do not otherwise trigger the liquidity standards codified in the proposed rules. Proposing Release at 23077.

status would be measured by an additional quantitative standard based on trading size and volume.) As proposed, a regular business of a securities dealer under Rule 3a5-4 would constitute a "routine pattern" of buying and selling securities such that trading has the effect of providing liquidity to other market participants as a result of one or more of the following standards:

- "routinely making roughly comparable purchase and sales of the same securities/government securities in a day;" or

- "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

- "earning revenue primarily by capturing the 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" (collectively, the "Qualitative Standards").

The Commission's introduction of the concept of "liquidity provider" to create *per se* dealer status effectively eliminates a statutory element of intent and longstanding interpretative precedent,[12] as well as replaces the statutory text of "regular" and "continuous" with an amorphous notion of "routine" patterns of liquidity, which the Commission imprecisely describes as falling somewhere between occasional and continuous.[13] First, we do not believe such a sweeping change is necessary in light of the significant market regulatory tools already granted to the SEC by the Market Reform Act and other market initiatives, as discussed below. Second, such a significant reordering of the trader exclusion requires more robust support than currently presented by the Commission. The Commission cites a single source, containing a single reference to liquidity, for its apparently "long-held" position that liquidity provision is *de facto* dealer status and, therefore, is justification for creating a single, *per se* test of dealer status based on its notions of liquidity.[14] As far as we can surmise, this position is fairly recent and, in

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[12] For example, a dealer is a market maker if it holds itself out as willing to buy and sell securities on a regular and continuous basis. 15 U.S.C. §78c(a)(38). *See, supra*, note 10. The Proposing Release asserts that activity, not intent matters. Proposing Release at 23062, fn. 91and 23066, fn. 131. Thus, if the rules are adopted as proposed, a trading firm will have no control over its status as a dealer regardless of the intent to be a trader. Instead, market perception apparently is all that matters regardless if a trader never holds out a dealer business to the public or promotes its business to outside clients, all contrary to the statutory text applicable to a market-maker and longstanding precedent guiding the dealer-trader distinction.

[13] Proposing Release at 23066.

[14] The SEC cites to a single statement in Securities Exchange Act Release No. 46745 (Oct. 30, 2002), stating a person may be a dealer by "acting as a *de facto* market maker whereby market professionals or the public look to the firm for liquidity." Release 46745, 67 F.R. at 67499. And, even in this 2002 release, the SEC pointed to other factors as relevant to the status as a dealer. References to liquidity provision as a factor in dealer status has been more recent and is one of many factors to consider, not the sole factor. *See also* Securities Exchange Act Release No. 83062 (April 18, 2018), 83 F.R. 21574, 21653 (May 9, 2018) (in proposing Regulation Best Interest, noting dealer activity "may" include, as part of a multi-factor test, acting as a liquidity provider); and Swaps Dealer Release, *supra*, note 10 at 80177 (noting a dealer may include, among other things, providing liquidity services to

contrast here, certainly has not been previously articulated as the exclusive factor relevant to applying the dealer-trader distinction.

Because of their deviation from accepted and historical precedent, as applied, we strongly oppose the use of the Qualitative Standards as a measure of dealer status.

II. MARKET RULES REGULATING PROFESSIONAL TRADING FIRMS

The Proposing Release prominently cites the lack of transparency to "detect, investigate, understand, or address market events, such as the 'flash rally' in October 2014," as justification for sweeping regulatory changes across all markets.[15] Reference to the Treasury market event of October 2014 reveals one of several flaws of the proposed dealer rules, namely they seem to treat market features of the Treasury and equity markets as if they are the same. In sharp contrast to implications of the Proposing Release, professional equity trading firms are regulated whereas the same may not be the case for market participants in the Treasury markets, although the Proposing Release does not make specific and distinct comparisons and contrasts in this respect. It should to the extent the Commission is justifying sweeping changes across all markets. For clarification, trading in the equity markets is subject to, among other things, the Commission's large trader program, CATs Reporting, and direct-market access protocols, each of which at the time of implementation was expected to enhance market transparency, discipline, and integrity.

A. Large Trader Reporting

Congress passed the Market Reform Act in response to the market break of October 1987 and perceived evolutionary changes in the equity markets caused by increased institutional and proprietary trading.[16] The relevant legislative history stated that the newly enacted market reforms would "strengthen the SEC's oversight of our securities markets and the participants in those markets. It will safeguard the capital formation mechanisms in this country. And,

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investors). Traders do not provide services, much less liquidity services, to outside investors. They trade strictly through their Prime Brokers. The Commission's enforcement staff in administrative enforcement actions has invoked liquidity as a measure of dealer status, but unlike the proposals here, only as part of a multi-factor test that has included other factors, such as, interacting with public customers, having a regular clientele, and acting as an underwriter. *See*, *e.g., In the Matter of Ironridge Global Partners, LLC*, Admin. Release No. 3298 (Nov. 5, 2015); and *In the Matter OX Trading,* Admin Release No. 722 (September 5, 2012).

[15] Proposing Release at 23056.

[16] The legislative history to the Market Reform Act shows that Congress believed that large trader reporting, among other things, was necessary because "[a]dvances in communications technology, together with the growth of institutional investors, has resulted in significant changes in trading activity and trading strategies. With huge pools of cash and the use of computer-driven automated trading strategies, institutions can rapidly trade millions of shares of stock and thousands of futures contracts in seconds. The markets of 1990 bear little resemblance to the markets of only a decade ago." 136 Cong. Rec. S12,548 (daily ed. Aug. 4, 1990) (statement of Sen. Riegel). The purposes justifying the Market Reform Act's large trader program are remarkably similar to the Commission's justification for proposed Rule 3a5-4. Presumably then, the broad tools granted the Commission by the Market Reform Act would be expected to suffice to address the SEC's current market-structure concerns or, if not, the SEC should explore more robustly the reasons they no longer suffice.

furthermore, it will protect investors and enhance investor confidence. This may be the most important feature of the bill."[17]

Among the tools to further these ends, the Market Reform Act granted the Commission authority to obtain the equity securities trading information of professional trading firms, categorized as "large traders."[18] Although it took more than two decades since Congress granted large trader authority, the SEC ultimately exercised it by adopting Rule 13h-1under the Exchange Act in response to the disruptive equity market events of May 2010.[19] Importantly, the large trader reporting program registers professional trading firms with the SEC and obtains equity trading information from periodic large trader reports on Form 13H, as well as from the recordkeeping and monitoring requirements imposed on the registered broker-dealers through which professional trading firms transact. At its adoption, the SEC stated that "[t]he large trader reporting requirements are designed to provide the Commission with a valuable source of useful data to support its investigative and enforcement activities, as well as facilitate the Commission's ability to assess the impact of large trader activity on the securities markets, to reconstruct trading activity following periods of unusual market volatility, and to analyze significant market events for regulatory purposes."[20]

Given the stated purposes and the authority of the Market Reform Act, it seems the large trader program was intended to address the precise market concerns the Commission now believes must be remedied by more expansive and aggressive dealer regulation. Nowhere in the Proposing Release, however, did the Commission address the large trader reporting program and why it has been ineffective in furtherance of the SEC's mission to ensure fair and orderly markets. Inasmuch as the initiatives of the Market Reform Act represented "a major step in giving . . . market regulators the tools they need to ensure the continued integrity of [the country's] capital markets,"[21] the Commission, at a minimum, should explain why the oversight tools granted by Market Reform Act need to be replaced by a super dealer regulatory regime that, by its own concessions, will fall short of achieving its regulatory goals.

B. Market Volatility Rule-Making Authority

Bolstering the market transparency tools of the Market Reform Act is the anti-manipulation rulemaking authority prescribed by Section 9(i) of the Exchange Act, which, among other things, gives the SEC rulemaking authority "to prohibit or constrain, during periods of extraordinary market volatility, any trading practice in connection with the purchase or sale of equity securities that the Commission determines (A) has previously contributed significantly to extraordinary

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[17] 136 Cong. Record S13,771 (daily ed. Sept. 28, 1990) (statement of Sen. Dodd).

[18] The Market Reform Act amended the Exchange Act to add Section 13(h) to enable the SEC to monitor the equity trading of professional trading firms. 15 U.S.C. §78m(h).

[19] Securities Exchange Act Release No. 64976 (July 27, 2011), 76 F.R. 46960 (Aug. 3, 2011).

[20] *Id.*

[21] 136 Cong. Rec. S12,548 (daily Aug. 4, 1990) (statement Sen. Dodd).

levels of volatility that have threatened the maintenance of fair and orderly markets; and (B) is reasonably certain to engender such levels of volatility if not prohibited or constrained."[22] The nexus of this two-decades-old rulemaking authority to the Commission's stated goals of enhancing stability, integrity, and investor protection is direct, precise, and clear. And, by its terms, it applies to all market participants across the equity markets, yet it remains unexercised. If the real goal were truly to enhance market stability and market integrity, it seems logical that the Commission would have considered this direct, albeit unexercised, rulemaking authority as a more cost-effective and less burdensome alternative to the sweeping, and admittedly less effective, proposals contained in Rule 3a5-4.

Accordingly, we respectfully request that the Commission strongly consider its rulemaking authority under Section 9(i) as an alternative to its current proposal.

C. CATs Reporting

Also citing May 2010 disruptive market events as justification for an improved audit trail, the SEC adopted Rule 613 under the Exchange Act to implement a system of order reporting across all equity markets.[23] CATs Reporting, currently an ongoing and comprehensive order audit program, covers the entire life cycle of equity trades of professional equity trading firms in order to allow "regulators to efficiently and accurately track all activity in NMS securities throughout the U.S. markets."[24] The Proposing Release omits explanation why CATs Reporting is insufficient to achieve enhanced market transparency and integrity. Indeed, CATs Reporting is still in its infancy and its benefits to the equity markets likely not fully appreciated. Thus, it seems any cost-benefit analysis would be seriously flawed in the absence of a full appreciation and analysis of CATs Reporting. For this reason, we cannot support proposed Rule 3a5-4 because it prematurely and less effectively addresses market-structure issues more appropriately reserved, not only for initiatives prescribed by the Market Reform Act, but also the enhancements expected of an improved order audit trail represented by CATs Reporting.

D. Risk-Reducing Measures

We are unaware of any systemic market risk posed by professional trading firms as a result of significant settlement fails that would lead the Commission to question market resiliency and investor protection. Although professional trading firms are not subject to the Commission's net-capital rule and the continuous maintenance of minimum levels of net capital, they are subject to capital requirements prescribed by the Prime Broker Letter. In particular, they are subject to minimum net equity requirements of at least $500,000 in cash and marketable securities. As a matter of course, and depending on the prime brokerage relationship, these minimums are many times that amount and, in practice, are set at cash and marketable securities typically in the tens of millions of dollars.

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[22] 15 U.S.C. §78i(i).

[23] Securities Exchange Act Release No. 67457 (July 18, 2012), 77 F.R. 45722 (Aug. 1, 2012).

[24] *Id.* at 45723.

The Proposing Release does not address the regulatory requirements of the Prime Broker Letter and how those prescribed protocols may benefit or fall short of benefitting the maintenance of orderly markets; nor does it analyze other market risk-reducing measures prescribed by Rule 15c3-5 under the Exchange Act, which like the large trader program, CATs Reporting system, and other rules, was adopted precisely to apply to the market access of all traders and to specifically address potential market vulnerabilities raised by high-speed, high-volume, and automated algorithmic trading and to prevent "naked" or unfiltered access to trading markets.[25] Again, any cost-benefit analysis that omits these important market initiatives seems flawed and less than credible justification for the costly and burdensome regulatory initiatives contained in the proposed, expanded dealer regulations.

III. CONCLUSIONS

In conclusion, and in response to one of the Commission's comment requests, many professional trading firms would be expected to restructure their operations to avoid dealer regulation, although quantification of that number or the market impact is difficult to ascertain absent a qualified economic analysis beyond this comment letter and most certainly the 60-day comment period. Some firms may exit the U.S. equity markets entirely. Others may modify their trading strategies or operations to qualify for the exclusion for small market participants. The $50-million asset test prescribed by the exclusion raises its own set of practical questions as to application. Namely, is it measured continuously in the same way net-capital compliance is measured, or is it measured periodically and, if so, how frequently? Is it measured on a levered or un-levered basis? Are the minimum net equity amounts required by the Prime Broker Letter carved out in recognition those amounts are segregated and not eligible for trading? That is, is the asset test based upon available trading power or all assets, regardless of their availability to be deployed for trading activities?

Additionally, how will the proposed registration requirements practically adapt to fluctuations of assets? Namely, will firms register and deregister as dealers as their assets fluctuate in value and, for those periods of fluctuation and non-registration, will contracts entered into be subject to voidability pursuant to Section 29(b) of the Exchange Act, while firms undertake the lengthy process for membership in a self-regulatory organization? The proposals do not address these and other practical implications. As noted above, we believe more effective and potentially more cost-efficient avenues of oversight already exist for the equity markets, which were not considered in the Proposing Release and, notably, any cost-benefit analysis seeking less burdensome regulatory alternatives. For these reasons, as detailed herein, we are unable to support and in fact strongly oppose the regulatory initiatives sought by proposed Rule 3a5-4.

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[25] Securities Exchange Act Release No. 63421 (Nov. 3, 2010), 75 F.R. 69792, 69794 (Nov. 15, 2010).

We appreciate the Commission's consideration of our comments and are available to discuss any additional information the Commission may seek in order to be fully informed in its decision-making process. Please do not hesitate to contact the undersigned at (202) 659-3905, with any questions or requests for more clarity.

Sincerely,

C. Dirk Peterson
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