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May 31, 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 a class of portfolio-management clients that have expressed interest in, and that share the views expressed below in respect of, recently proposed dealer rules – Rule 3a5-4 and Rule 3a44-2 under the Securities Exchange Act of 1934 ("Exchange Act").[1] The Securities and Exchange Commission ("Commission" or "SEC") recently proposed these rules to codify a definition of "regular business" for purposes of applying the dealer-trader distinction under the Exchange Act. The proposed rules currently exclude investment companies registered with the SEC pursuant to the Investment Company Act of 1940 ("Company Act") and small market participants owning or controlling assets of less than $50 million.

We appreciate the opportunity to comment on proposed Rule 3a5-4 and Rule 3a44-2 and their stated goals of promoting transparency, stability, integrity, resiliency, and investor protection in the nation's securities/government securities trading markets via principles of functional dealer regulation.[2] By their terms, the rules could extend dealer regulation to segments of the portfolio-management sector, a sector already under the Commission's oversight. As conceived in the case of portfolio management and trading, therefore, the rules are unnecessarily overinclusive, create a duplicative and conflicting system of regulation (with few, if any, discernible benefits), and, by the Commission's own admission, by themselves will not lead to less volatile or to more stable trading markets. For these reasons, we cannot support the proposed rules in their current form and, in fact, strongly oppose them.

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

[2] *Id.* at 23056 and 23060.

Should the Commission proceed to adopt Rule 3a5-4 and Rule 3a44-2, we request that it consider also preserving the trader exclusion, by extending the blanket exclusions from the entirety of any final version, to: (1) all unregistered funds excluded from the Company Act; and (2) asset managers registered under the Investment Advisers Act of 1940 ("Advisers Act") and the accounts they manage (collectively, the "Excluded Traders"). A blanket exclusion for the Excluded Traders, therefore, would continue to recognize their distinct businesses and the separate regulatory regimes envisioned by Congress as more appropriately tailored to their portfolio management and trading.

I. EXCHANGE ACT DEALER REGULATION

A. Regulation of Dealers and Government Securities Dealers

Section 15 of the Exchange Act grants the SEC authority to register and to regulate persons that are dealers.[3] Section 3(a)(5) of the Exchange Act broadly defines a dealer, in pertinent part, as "any person engaged in the business of buying and selling securities . . . for such person's own account through a broker or otherwise."[4] This definition excludes persons that buy and sell securities for their own accounts but not as part of a "regular business" – an exclusion commonly understood as the "trader exclusion."[5] For dealers specializing in a government securities business, Section 15C of the Exchange Act grants the SEC the authority to register and regulate government securities dealers.[6] Section 3(a)(44) of the Exchange Act defines a "government securities dealer" generally to mean "any person engaged in the business of buying and selling

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[3] 15 U.S.C. §78o. Registered dealers are required to become members of one or more self-regulatory organizations ("SROs"), such as one or more national securities exchanges on which they have trading privileges and/or the Financial Industry Regulatory Authority ("FINRA"). 15 U.S.C. §78o(b)(8). They are also subject to, among other things, specialized antifraud obligations prescribed by Section 15(c) of the Exchange Act and various operational rules, including the Commission's net-capital and customer protection rules [17 C.F.R. §240.15c3-1 and 17 C.F.R. §240.15c3-3]. 15 U.S.C. §78o(c). They are also required to maintain books and records and are subject to financial reporting to the SEC and relevant SROs. 15 U.S.C. §78q; and 17 C.F.R. §240.17a-3; §240.17a-4; and §240.17a-5.

[4] 15 U.S.C. §78c(a)(5)(A).

[5] 15 U.S.C. §78c(a)(5)(B). Another exclusion applies to bank activities, including a bank that buys and sells securities for investment purposes on behalf of accounts for which the bank acts as trustee or fiduciary. 15 U.S.C. §78c(a)(5)(C)(ii)(II). *See infra* notes 43-45 and accompanying text for a discussion if bank-sponsored funds may be subject to the proposals, even though the bank managing these funds is expressly excluded from dealer regulation.

[6] 15 U.S.C. §78o-5. Government securities dealer regulation establishes shared jurisdiction that divides regulatory authority among the Department of Treasury, the SEC, FINRA, and banking regulators to regulate government securities dealers. Specialized government securities dealers are subject to financial responsibility and recordkeeping rules prescribed by Treasury. *See* 17 C.F.R. §402 (minimum net capital); 17 C.F.R. §403.5 (custody requirements).; and 17 C.F.R. §§404.2 and 404.3 (recordkeeping and records preservation).

government securities for his own account, through a broker or otherwise . . . ."[7] This definition similarly excludes traders in government securities.[8]

Historically, portfolio management and trading have relied on the trader exclusion based on longstanding norms and interpretative positions summarized below. These longstanding norms should not be overturned by expanding dealer regulation to capture the Excluded Traders.

B. Scope of the Proposed Dealer Rules

1. Requests for Comment

Perhaps in anticipation of the expansive reach of the proposals, the SEC asked if private funds (*i.e.*, those organized in reliance on exclusions from the Company Act in Section 3(c)(1) and Section 3(c)(7)), asset managers, and other market participants should be excluded or, if captured, specifically whether private funds could comply with substantive dealer regulation.[9] The SEC further asked if the concept of "liquidity provider" is an appropriate measure of dealer status.[10]

All unregistered funds excluded from the Company Act (not just registered funds) and all registered investment advisers, including their managed accounts, should not be regulated as dealers for the reasons discussed below. The concept of "liquidity provider" is a flawed measure of dealer status to the extent it establishes, in effect, an irrebuttable, *per se* test of liquidity based on trading strategies as synonymous with dealer activity.[11] The Commission's casual disregard of business intent in favor of a single-element, *per se* liquidity test based on trading strategies is hostile to reliance on established precedent and operating norms that traditionally recognized business intent as an important element of the dealer-trader distinction.[12]

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[7] 15 U.S.C. §78c(a)(44). Government securities include, not only Treasury securities (*e.g.,* direct obligations of, and/or securities guaranteed by, the United States), but also the securities of government-sponsored agencies and enterprises. *See* 15 U.S.C. §77c(a)(42).

[8] 15 U.S.C. §78c(a)(44)(A).

[9] Proposing Release at 23064 and 23077.

[10] *Id*. at 23070.

[11] In an attempt to have it both ways, the Commission said it would retain historical precedent only insofar as it would apply to market participants that do not otherwise trigger the liquidity standards proposed to be codified in the rules. Proposing Release at 23062, fn. 87, and 23077.

[12] The Proposing Release asserts that function, not intent, now matters. Proposing Release at 23062, fn. 91, 23065, 23066, fn. 131, and 23079. Thus, if the rules are adopted as proposed, an Excluded Trader will have no control over its status as a dealer, even though it is legally organized and regulated consistent with its fund investment and portfolio-management business and it never holds its business out to the public as a dealer business, all contrary to the statutory text of the market-maker definition incorporating intent to hold out a market-making business and longstanding precedent guiding the dealer-trader distinction. *See infra* notes 41-42 and accompanying text regarding dealer-trader precedent.

Left unanalyzed were the irreconcilable regulatory consequences of imposing a dealer regime on the fund sector and its registered investment advisers (and/or control affiliates in a fund complex). For instance, the leverage prescriptions of the Commission's net-capital rule[13] pose an existential threat to leveraged funds because those funds most certainly would be unable to comply and continue operations consistent with their stated business intent and disclosures to investors. Indeed, their inability to comply with the Company Act's leverage restrictions is one reason they are excluded from the Company Act.[14] Omitted from consideration was the extent to which a back-door imposition of leverage restrictions via the Exchange Act's net-capital rule could possibly be consistent with Congress' clear and longstanding deregulatory intent for unregistered funds. Furthermore, the application of the net-capital rule more broadly frustrates effective portfolio management because the make-up of a securities portfolio, fluctuations of net-asset value, and liquidations of portfolio holdings for redemptions or otherwise would hardly be expected to comply with the continuous capital maintenance requirements and the attendant securities haircuts, concentration charges, and withdrawal limits of the net-capital rule.[15] Essentially, the Commission here would be forcing a square peg into a round hole.

Standards of care also are in conflict. An investment adviser is a fiduciary where a dealer most certainly is not. Moreover, the proposed rules jeopardize accepted portfolio-management fee structures to the extent the trading activities of registered investment advisers (and/or their control affiliates) are now functionally treated as dealer activities. For example, the Advisers Act conditionally permits investment advisers to charge a carried interest (*i.e.* profits interest) based on total fund performance, including, in part, performance derived from portfolio trading.[16] In conflict, FINRA's prohibition against sharing in customer profits could extend to carried interest presumably since the proposed liquidity standards recharacterize portfolio management and trading now as dealer and/or *de facto* market-making activity.[17] These examples of conflicting

[13] 17 C.F.R. §240.15c3-1(a)(1)(i) and (ii) and (c)(1).

[14] The legislative history of the private fund exclusions from the Company Act reveals Congress knew that private funds had potential to hold substantial assets but the public interest was insufficient to warrant subjecting them to the substantive governance and other operational regulations of the Company Act. *See, e.g.,* Investment Trusts and Investment Companies: Hearings on S. 3580 Before the Subcomm. on Securities and Exchange of the Senate Comm. on Banking and Currency, 76th Cong., 3rd Sess., 179 (1940) (statements of Senator Wagner and David Schneker, Chief Counsel, Investment Trust Study, SEC). Not only did Congress not seek to restrict the universe of unregulated funds, it expanded it in 1996 to exclude a class of private funds comprised of qualified purchasers. *See* National Securities Markets Improvement Act of 1996, Pub-L 104-290 (1996).

[15] 17 C.F.R. §240.15c3-1(c)(2)(vi), (c)(2)(vi)(M), and (e)(2)-(3).

[16] *See* 17 C.F.R. §275.205-3.

[17] FINRA Rule 2150(c)(1)(A). Rule 2150(c)(2) conditionally permits a profits fee but only if a broker-dealer is acting in its dual capacity as investment adviser. However, application of dealer regulation to investment advisers would create irreconcilable issues of the capacity of the adviser where an adviser exercises discretion and/or charges a management fee in respect of the management of an unregistered fund, including portfolio trading. On one hand, the SEC has taken the position that the exercise of discretion and the charge of an asset-based fee are investment adviser functions. *See* Securities Exchange Act Release No. 51523 (April 12, 2005), 74 F.R. 20424 (April 19, 2005). On the other hand, implication of the liquidity standards treats portfolio trading as *per se* dealer activity. Therefore, in what capacity does the adviser manage portfolio trades – as fiduciary per the Advisers Act or as dealer per the Exchange Act?

regulatory impacts are strong evidence that inexplicably regulating a portfolio-management business as if it legitimately were a dealer business is demonstrably unsupportable by separate and oftentimes conflicting regulatory regimes.

The layering of dealer regulations onto the portfolio-management sector also creates a duplicative system of new regulations that the SEC itself conceded "will not by themselves necessarily prevent future market disruptions . . . ."[18] Contrary to the implications of the Proposing Release, unregistered funds and their asset managers are not left unregulated. In fact, the Commission has examination authority over all unregistered fund activities, including access to all trading and financial records required to be preserved by the fund's asset manager.[19] Moreover, unregistered fund assets must be in the custody of a bank or registered broker-dealer;[20] the fund is subject to independent audit;[21] fund limited partners/members must annually receive audited financial statements;[22] and all portfolio management and trading, including any risks posed by carried interest, are subject to fiduciary standards,[23] all of which is under the Commission's regulatory oversight and examination authority under the Advisers Act.

Moreover, the SEC already has other regulatory tools at its disposal to more appropriately address market-structure issues to "detect, investigate, understand, or address market events."[24] And these tools go well beyond and more robustly enhance market transparency than Form PF filings cited by the Proposing Release. For starters, the institutional equity trading of

[18] Proposing Release at 23060.

[19] 17 C.F.R. §275.204-2(a)(3), (a)(7), (c)(1), and (e)(1). We are hard-pressed to see how the SEC's broker-dealer or Treasury's government securities recordkeeping requirements appreciably improve the Commission's oversight posture of Excluded Traders' recordkeeping.

[20] 17 C.F.R. §275.206(4)-2(a)(1). The Advisers Act custody rule and fiduciary standards more appropriately regulate fund custody for portfolio management and trading purposes than Exchange Act Rule 15c3-3, which requires dealers to reduce securities in custody to possession and control and lock in and perform reserve calculations of funds moving through a special reserve bank account. Therefore, aspects of Rule 15c3-3 would most surely inhibit a nimble portfolio-management process.

[21] 17 C.F.R. §275.206(4)-2(b)(4). The independent audit under the Advisers Act would largely duplicate the annual audit requirements of Exchange Act Rule 17a-5.

[22] 17 C.F.R. §275.206(4)-2(b)(4)(i).

[23] *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 191-192 (1963) (stating that the Advisers Act reflected "a congressional recognition 'of the delicate fiduciary nature of an investment advisory relationship,' as well as a congressional intent to eliminate, or at least to expose, all conflicts of interest which might incline an investment adviser— consciously or unconsciously—to render advice which was not disinterested") (footnotes omitted). The fiduciary standard of care between an adviser and its clients, such as an adviser to a sponsored unregistered fund, generally includes the duty to: (i) disclose to, and in specified cases obtain the consent of, clients of conflicts of interest, (ii) obtain best execution of client portfolio transactions, (iii) recommend suitable transactions, and (iv) act with utmost and exclusive loyalty to clients. *See* Investment Advisers Act Release No. 5248 (June 5, 2019), 84 F.R. 33669 (July 12, 2019). *See also In the Matter of Alfred C. Rizzo*, Investment Advisers Act Release No. 897 (Jan. 1, 1984); *In re Kidder, Peabody & Co., Inc.*, 43 S.E.C. 911, 915 (1968); and *Interfinancial Corporation*, SEC No-Action Letter (pub. avail. Mar. 18, 1985).

[24] Proposing Release at 23056.

unregistered funds and fund complexes is subject to reporting on Form 13H as part of the Commission's large trader reporting regime.[25] Also significant is the reporting of the entire life cycle of a fund's equity trades through the consolidated audit trail ("CATs Reporting").[26] Other reporting includes similar and some overlapping reporting of discretionary assets under management required by Rule 13f-1 and Form 13F.[27] The express market utility of these reporting regimes was to enhance the oversight, transparency, and integrity of the markets by increasing the SEC's access to market data and trading history.[28]

Left undeployed is three-decades-old rulemaking authority codified in Section 9(i) of the Exchange Act, which authorizes the Commission "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 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."[29] In support of the proposals, the Commission viewed certain trading practices –

[25] 17 C.F.R. §240.13h-1. The SEC adopted Rule 13h-1 in 2011 [Securities Exchange Act Release No. 64976 (July 27, 2011), 76 F.R. 46960 (Aug. 3, 2011)] under authority granted by the Market Reform Act of 1990 [Pub. L. 101-432, 104 Stat. 963 (October 16, 1990)] ("Market Reform Act"), which comprises a set of initiatives in response to the market break of October 1987 and perceived evolutionary changes in the equity markets caused by increased institutional and proprietary trading. 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). Congress in 1990 recognized that advancements in trading were not tantamount to dealer status requiring expanded dealer regulation. Nevertheless, the Commission now almost verbatim borrows the familiar refrain of automated market trading and evolutionary technology as the impetus for the proposed dealer rules, thus begging the question why the Commission has again returned to the regulatory well, as it were, given the tools provided by Market Reform Act.

[26] 17 C.F.R. §242.613 was first adopted in Securities Exchange Act Release No. 67457 (July 18, 2012), 77 F.R. 45722 (Aug. 1, 2012) and, over the past eight years since, SROs have submitted multiple reporting plans and the Commission has adopted enhancements to the transparency and financial information in CATs Reporting most recently two years ago.

[27] 17 C.F.R. §13f-1.

[28] Said the Commission, "[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." Release No. 64976 at 46960. At adoption of Rule 613, the Commission lauded CATs Reporting as allowing "regulators to efficiently and accurately track all activity in NMS securities throughout the U.S. markets." Release 67457 at 45723.

[29] 15 U.S.C. §78i(i). Congress included the authority in Section 9(i) among a package of market-regulatory tools contained in the Market Reform Act, all of which Congress emphasized would "strengthen the SEC's oversight of . . . securities markets and the participants in those markets. It will safeguard the capital formation mechanisms in this country. And, furthermore, it will protect investors and enhance investor confidence. This may be the most important feature of the bill." 136 Cong. Record S13,771 (daily ed. Sept. 28, 1990) (statement of Sen. Dodd).

the removal of liquidity by rapid electronic trading – as contributing to disruptions of the Treasury market.[30] If addressing trading practices unduly contributing to market volatility were truly the goal, it seems invoking the authority under Section 9(i) and seeking similar authority for the Treasury market, if necessary, would be a more relevant and constructive first path forward than expanding dealer regulations having dubious utility and difficult enforceability.

A discussion of the Commission's market-based authority, however, is conspicuously absent from consideration. No mention was made of the success, failure, or any needed modifications of the large trader regime or the CATs Reporting program, or the reasons for leaving authority unexercised, or additional legislative authority needed to address any remaining gaps, if any, in the Treasury market compared to the equity markets. Because the expansion of the proposed dealer rules, by the Commission's own admission, will not entirely achieve the stated market goals, we recommend replacing them with a more robust exploration of the Commission's current authority under the Market Reform Act (exercised and unexercised), current trade reporting regimes, and any other market-based alternatives to more appropriately tailor rulemaking to the stated goals of market transparency, stability, integrity, resiliency, and attendant investor protection.

2. Proposed Meaning of Regular Business

The proposed rules seek to identify a regular dealer business on the basis of three qualitative standards and, in the case of government securities dealers, an additional quantitative standard, each intended as a proxy for "liquidity" as a *per se,* codified test of a dealer business. According to the proposals, a regular business of a securities or a government securities dealer constitutes a "routine pattern" of buying and selling securities/government securities such that trading has the effect of providing liquidity to other market participants as a result of one or more of the following qualitative 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").

An additional quantitative standard is added to identify a regular business of a government securities dealer if trading in each of four out of the last six months constituted more than $25 billion of the trading volume of government securities ("Quantitative Standard").

[30] Proposing Release at 23060.

The Qualitative Standards incorporate, in part, traditional portfolio management and trading strategies that heretofore have not been viewed by themselves as dealer activity. That is, portfolio management has historically included, among other things, hedging and arbitrage strategies that implement offsetting long/short positions in the same or similar securities,[31] effect repos and reverse repo transactions under similar strategies using government securities,[32] and seek to derive value, positive fund performance, and portfolio-trading revenues by taking advantage of pricing differentials in bid-ask spreads. Does the daily implementation of these historical portfolio management strategies mean an Excluded Trader is now a *de facto* market maker because the strategy "routinely makes roughly comparable purchase and sales of the same securities"? Or earns revenue as dealer by "primarily by capturing the bid-ask spreads, by buying at the bid and selling at the offer"? Or by taking long/short positions or seeking arbitrage opportunities, are portfolio trading strategies "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" as *de facto* market maker?

Additionally, the Commission's introduction of "liquidity provider" to create *per se* dealer status based on trading strategies effectively eliminates a statutory element of intent and longstanding interpretative precedent, as well as replaces the statutory text of "regular" and "continuous" with an amorphous notion of "routine" patterns of providing liquidity,[33] which the Commission describes imprecisely as falling somewhere between occasional and continuous.[34] Aside from the unenforceability of the Qualitative Standards from a compliance and administration standpoint, they are guaranteed to capture a class of inadvertent dealers that extend beyond unregistered funds and certain of their affiliates under common control and likely would extend to trading activities of family offices, qualified retirement benefit plans, and insurance company general accounts, all active securities/government securities traders that have not on their face been viewed until now as dealers.

A significant reordering of the trader exclusion by reference to the proposed liquidity proxies in the Qualitative and Quantitative Standards would reasonably expect more robust support than a single source, containing a single reference to liquidity, as an apparently "long-identified" position that liquidity provision is *de facto* dealer status and, therefore, justification for using notions of liquidity based on trading strategies as a single, *per se* test of a regular dealer

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[31]*See, e.g., Continental Grain Company*, SEC No-Action Letter (pub. avail. Nov. 6, 1987) and *Louis Dreyfus Corporation*, SEC No-Action Letter (pub. avail. July 23, 1987) (no-action confirming that active government securities traders that deployed long/short trading strategies could permissibly rely on the trader exclusion).

[32] *Id.*

[33] For example, and contrary to the Commission's assertion that no statutory element of intent exists, a dealer is a market maker if it holds itself out as willing to buy and sell securities on a *regular* and *continuous* basis. *See infra* notes 41-42 and accompanying text for a discussion of the dealer-trader interpretative precedent.

[34] Proposing Release at 23066.

business.[35] As far as we can surmise, this newly conceived "long-identified" position certainly has not ever before been the exclusive factor animating the dealer-trader distinction.

Because of their material deviation from accepted and historical precedent, as applied, their imprecision and questionable enforceability, and their capture of traditional portfolio management strategies, we strongly oppose the use of the Qualitative and Quantitative Standards to reclassify and regulate the regular business of the Excluded Traders as a dealer business.

3. Proposed Meaning of Account

The meaning of account is a key element of the proposed rules. The rules apply to an account in the name of the market participant itself. They do not include an account in the name of a registered fund or a small market participant but do extend to "control" accounts[36] and those "held by" or for the "benefit of" market participants other than accounts for the benefit of a registered fund, a small market participant, or a registered securities/government securities broker-dealer.

The proposals construct a complex regime of aggregation and attribution principles in order to address a manufactured concern of avoidance structuring, which has the effect of casting a wide net to capture accounts at the "legal-entity level," presumably meaning accounts under common control in a fund complex. This potentially creates multiple inadvertent dealers within a single fund complex and issues of compliance whether to register as dealer multiple funds or a single enterprise-wide adviser. Not clear is if the principle of control accounts and related principles of attribution and aggregation extend to remote affiliations under common control in a holding company structure. We presume the answer is they do not, although the Proposing Release is

[35] For this proposition, the SEC cites several times to a single statement in Securities Exchange Act Release No. 46745 (Oct. 30, 2002), 67 F.R. 67496, 67499 (Nov. 5, 2002) ("2002 Release"), 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." 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 seems more recent and is always stated as 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 Securities Exchange Release No. 63452 (Dec. 7, 2010), 75 F.R. 80174, 80177 (Dec. 21, 2010) ("Swaps Dealer Release") (noting a dealer may include, among other factors, providing liquidity services to investors). Unregistered funds, as exempt traders, do not provide any services, much less liquidity services, to outside customers. They trade strictly for their own account. 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).

[36]A "control" account is intended to carry the meaning of control prescribed by Rule 13h-1 under the Exchange Act. That is, control is measured by voting rights, rights to sell, and rights based on contributions to or amounts received on dissolution of 25% or more of equity of another person. Control also means the power to direct or cause the direction of management or policies of another by ownership, contract or otherwise, although control solely by as result of discretionary management would not be a "control" account for these purposes. The Commission may wish to consider expressly adding to the rule language that discretionary management is not by itself evidence of control.

unclear on the scope of control across a fund and portfolio-management organization. This should be clarified, including specifically if the construction of information barriers would sufficiently segregate portfolio management and trading across an enterprise.

Regardless of the granular application, the overly complicated attribution of dealer regulation to an organization of investment funds, advisers, general partners, and member managers under common control begs the general question why such a complicated scheme is needed to regulate a sector already subject to the oversight of the Commission, its examination program, extensive trade reporting requirements, and risk management protocols. For these reasons, we believe any account in the name and for the benefit of an Excluded Trader should be excluded entirely from the meaning of account to the same extent as a registered fund and a small market participant.

II. UNREGISTERED FUNDS AND THEIR ASSET MANAGERS

A. Dealer-Trader Precedent

On one hand, the Company Act identifies the regular business of an investment fund (registered or unregistered) as "any issuer which is or holds itself out as being engaged primarily . . . in the business of investing, reinvesting, or trading in securities."[37] The Company Act expressly recognizes the distinct business of a dealer by excluding it from registration and regulation, even though dealers own, hold, and trade in securities, as captured by the Company Act definitions of investment company.[38]

On the other hand, registered and unregistered investment funds have not heretofore been regulated as dealers under the Exchange Act in reliance on the trader exclusion in recognition of their regular businesses as investment funds as provided by the Company Act. In short, Congress recognizes the distinct and separate businesses of a fund and a dealer under the Company Act and the Exchange Act, distinctions that have operated for over 80 years. Indeed, we are not aware of any enforcement or administrative actions that have found any *bona fide* fund to also be a dealer and the SEC cites to none. Thus, contrary to implications in the Proposing Release that the trader exclusion applies solely to an "ordinary investor"[39] or to "ordinary traders,"[40] the Company Act envisions investment funds as securities traders, even active ones, that more than "routinely" invest, reinvest, own, hold, and trade in securities for their own accounts. The Commission also has recognized as much by not only preserving the trader exclusion for

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[37] 15 U.S.C. §80a-3(a)(1)(A). The Company Act also prescribes an asset test to capture issuers in the business of "investing, reinvesting, owning, holding, or trading in securities, and [owning] . . . investment securities having a value exceeding 40 per centum of the value of [the] issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis." 15 U.S.C. §80a-3(a)(1)(C).

[38] Dealers are excluded from the Company Act to the extent they are "primarily engaged in the business of underwriting and distributing securities issued by other persons, selling securities to customers . . . and acting as market intermediary [*i.e.,* market maker or dealer], or any one or more of such activities, whose gross income normally is derived principally from such business and related activities." 15 U.S.C. §80a-3(c)(2).

[39] Proposing Release at 23058.

[40] *Id.* at 23059

registered funds under the proposals but also previously acknowledging that unregistered funds structured as hedge funds are excluded traders.

That is, in 1992 the SEC staff reviewed the activities of hedge funds in response to a request from Congress concerning their regulatory treatment and the potential systemic market risk posed by their size and the scope of their securities trading.[41] The Markey Letter noted that hedge funds do not typically register with the SEC as dealers in reliance on the trader exclusion that distinguishes traders from dealers, even though traders buy and sell securities for their own accounts like dealers. The Markey Letter also cited to the Commission's authority over large traders as having the potential to enhance the market transparency of hedge-fund trading, thus rendering consideration of their dealer status unnecessary.

In our personal practice over the years, we have addressed from time to time the trader exclusion in response to securities and bank regulatory queries for certain private and bank-sponsored funds, distinguishing the fund as trader from a securities dealer based on recognized indicia of a regular dealer business enunciated in a line of SEC and SEC staff positions. Guided by the SEC and its staff, the "in the business" and "regular business" elements of the dealer definition mean that "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)."[42] The intent to engage in a fund business, and not a dealer business, has guided the fund sector for nearly a century to confirm fund portfolio management and trading appropriately belong under the trader exclusion and within the regulatory prescriptions of the Company Act and the Advisers Act. Particularly troubling, however, is the Commission's apparently unburdened disregard of this precedent and custom as applied to the Excluded Traders to establish liquidity based on trading strategies as a single element, *per se* test of dealer status unsupported by historical interpretative positions or clear legislative intent.

B. Business Intent

The business intent of unregistered funds and their asset managers should put to rest any perception portfolio management and trading should be treated functionally as a dealer business.

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[41] *See* Letter from Richard C. Breeden, Chairman, Securities and Exchange Commission, to Edward J. Markey, Chairman, Subcommittee on Telecommunications and Finance, Committee on Energy and Commerce, U.S. House of Representatives (June 12, 1992) (the "Markey Letter").

[42] 2002 Release, *supra*, note 35 at 67499. *See also* 15 U.S.C. 78c(a)(38) (statutory text includes holding out as willing to buy and sell securities in market maker definition); Swaps Dealer Release, *supra* note 35 at 80178 ("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"); *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").

Fundamentally, the business of an unregistered fund is the pooling of investor capital for purposes of managing a portfolio of securities by investing, reinvesting, owning, holding, and trading in securities for the fund's account, all envisioned by the Company Act. Some unregistered funds issue redeemable securities allowing investors to periodically put their interests back to the fund for a proportional share of the fund's net-asset value. Unregistered funds have no employees. Rather they are controlled by management companies that are registered as investment advisers with, and under the oversight and examination authority of, the SEC pursuant to the Advisers Act. Investors invest in funds, registered or unregistered, based on material disclosures of the fund's business intent to invest and trade in securities as a fund consistent with well-articulated investment objectives and investment guidelines to be carried out by the fund's investment adviser.

A dealer business is not managed by an external manager, does not pool investor capital to be deployed consistent with investment management guidelines, and does not issue redeemable puts to its shareholders. In short, the clear expectations of investors, when subscribing to interests in an unregistered fund, are they are obtaining a proportionate interest in the underlying assets of the fund consistent with well-articulated investment guidelines and investment management policies, consistent with the fund's regular business of investing, reinvesting, owning, holding, and trading in securities. Fund investors have no expectation they are investing in a dealer business subject to an entirely separate regulatory regime that would be in material conflict with the effective management of the fund's assets.

Congress deregulated a class of funds that it believed should not be subject to the Securities Act of 1933 ("Securities Act")[43] or the Company Act. The Company Act's fund exclusions, however, extend beyond those for private funds relying on Sections 3(c)(1) or 3(c)(7) and include bank-collective and common investment trusts (regarded as viable alternatives to mutual funds in the qualified plan marketplace) under exclusions in Section 3(c)(3) and Section 3(c)(11) to the extent the funds are "maintained by a bank."[44] The SEC should consider clarifying if bank-related funds are "accounts" for purposes of the proposed rules and therefore intended or not intended to be captured as dealers.[45] Of course, extending a blanket exclusion to all unregistered funds would resolve difficult jurisdictional issues over banks exempt in their own right from Section 3(a)(5) and their fiduciary and trust accounts, as well as preserve Congress' deregulatory intent for all unregistered funds.

[43] Private funds rely on the private offering exemption in Section 4(a)(2) of the Securities Act [15 U.S.C. §77d(a)(2)], thus limiting their offerings to accredited investors or qualified purchasers, depending on the structure of the fund. Other unregistered funds, such as bank collective investment funds, are tax-exempt funds that offer interests in exempt offerings in reliance on Section 3(a)(2) of the Securities Act. *See* 15 U.S.C. 77c(a)(2).

[44] *See* 15 U.S.C. §80a-3(c)(3) and §80a-3(c)(11).

[45] Possibly in anticipation of the broad reach of the proposed rules, the SEC asked if an account held in the name of a bank should be expressly excluded from the account definition. Proposing Release at 23076. Although banks, when acting as a fiduciary or a trustee on behalf of an account, are not dealers when buying and selling securities for the account [15 U.S.C. §78c(a)(5)(C)(ii)(II)], the proposed rules are not clear if the fiduciary/trustee account itself is intended to be captured. The meaning of "account" under the proposed rules seems to capture bank-sponsored collective/common investment trusts as "accounts" that would not independently qualify for the bank-dealer exclusions prescribed by Section 3(a)(5)(C) of the Exchange Act or an exclusion from the proposed rules.

If adopted in their current form, the proposed dealer rules would preserve the trader exclusion only for registered funds, even though both registered and unregistered funds perform some of the same portfolio management and trading strategies potentially captured by the proposed Qualitative and Quantitative Standards. The Commission makes this distinction because registered funds are regulated by the Company Act, and unregistered funds are not.[46] Aside from the questionable relevance of the Company Act's corporate governance and shareholder-protection provisions to market structure, much of the Company Act's regulatory benefits cited by the Commission extend to the unregistered fund sector by operation of the Advisers Act's prudential and codified regulations pertaining to custody, conflicts of interest management, and annually updated compliance policies.[47] To the extent that unregistered funds are not subject to the Company Act's leverage and capital-structure restrictions, Congress expressly intended this deregulatory result in 1940 and again in 1996 – a legislative intent that should not be undermined by a system of back-door dealer regulation proposed by Rule 3a5-4 and Rule 3a44-2.

IV. CONCLUSION

The dealer rule proposals are not carefully tailored to achieve their stated goals of transparency, stability, integrity, resiliency, and investor protection in the Treasury and equity markets, as conceded by the Commission. As applied to the Excluded Traders, the proposed rules would be duplicative, conflicting, and costly, without achieving the stated goals or enhancing market stability. Importantly, they reorder in significantly detrimental ways segments of the portfolio-management sector. There is a reason that business intent has, in part, predominantly animated the dealer-trader distinction for nearly a century. It is because it still matters. The portfolio management and trading sector has relied on business intent to legally organize portfolio trading functions and to comply with separate regulatory regimes consistent with the dealer-trader distinction since inception of the Exchange Act and the Company Act six years later. The advent of automated, algorithmic, and high-frequency trading and a single test of perceived liquidity based on trading strategies should not change this longstanding reality.

For the reasons discussed herein, the proposed rules should not be applied to the Excluded Traders in their current iteration and their historical reliance on the trader exclusion should be preserved to the same extent as a registered fund.

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[46] Proposing Release at 23057.

[47] *See id.* at 23063.

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
McIntyre & Lemon, PLLC