Case No. 4:24-cv-00250-O

IN THE

NORTHERN DISTRICT OF TEXAS
FORT WORTH DIVISION

NATIONAL ASSOCIATION OF PRIVATE FUND MANAGERS,
ALTERNATIVE INVESTMENT MANAGEMENT ASSOCIATION, LIMITED,
and MANAGED FUNDS ASSOCIATION,

Plaintiffs,

—v.—

SECURITIES AND EXCHANGE COMMISSION,

Defendant.

BRIEF FOR *AMICUS CURIAE* COMMITTEE ON CAPITAL MARKETS REGULATION IN SUPPORT OF PLAINTIFFS

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INTEREST OF AMICUS CURIAE[1]

Founded in 2006, the Committee on Capital Markets Regulation (the "Committee") is dedicated to enhancing the competitiveness of the U.S. capital markets and ensuring the stability of the U.S. financial system. The Committee is an independent and nonpartisan 501(c)(3) research organization, financed by contributions from individuals, foundations, and corporations.

The Committee believes that hedge funds play a critical role in the U.S. capital markets and economy. Hedge fund investors include pension funds, university and hospital endowments, and other non-profit foundations. Investor demand for hedge funds has been growing rapidly: total assets managed by hedge funds grew from $2.6 trillion in 2013 to $5 trillion in 2023. *See* SECURITIES AND EXCHANGE COMMISSION ["SEC"], Private Funds Statistics: Fourth Calendar Quarter 2014, at 5 (Dec. 30, 2015), https://www.sec.gov/divisions/investment/private-funds-statistics/private-funds-statistics-2014-q4.pdf; SEC, Private Funds Statistics: Second Calendar Quarter 2023, at 6 (Jan. 9, 2024), https://www.sec.gov/files/2023q2-private-funds-stats20240109.pdf. Hedge funds also play a vital role in supporting liquidity and price efficiency in U.S. securities markets. In particular, their participation in the market for U.S. Treasuries benefits American taxpayers by lowering the costs of government borrowing.

The SEC rule at issue here would expand the definition of securities dealers to include certain hedge funds, which would cause hedge funds to reduce their participation in U.S. securities markets, to the detriment of U.S. capital markets competitiveness and resulting in unwarranted costs for U.S. companies, investors, and the U.S. government.

[1] The parties have consented to this filing. No party's counsel authored this brief in whole or part, and no one other than the Committee, its members, or counsel contributed money for the brief's preparation or submission."

INTRODUCTION AND SUMMARY OF ARGUMENT

On February 6, 2024, the SEC promulgated new rules under the Securities Exchange Act of 1934 (the "Exchange Act"). *See* Further Definition of ''As a Part of a Regular Business'' in the Definition of Dealer and Government Securities Dealer in Connection With Certain Liquidity Providers, Exchange Act Release No. 34–99477, 89 Fed. Reg. 14,938 (Feb. 29, 2024), https://www.federalregister.gov/documents/2024/02/29/2024-02837/further-definition-of-as-a-part-of-a-regular-business-in-the-definition-of-dealer-and-government (A.R. No. 2) [hereinafter the "Final Rule"].

The Final Rule constitutes a significant expansion of the regulatory regime for securities dealers based on an unlawful and unprecedented redefinition of the statutory term "dealer." Under the SEC's redefinition, a securities market participant would be deemed a "dealer" solely on the basis that its trades have the effect of "providing liquidity" to securities markets. The Final Rule thus omits the fundamental distinction between brokers and dealers and other securities market participants: a broker or dealer transacts in securities markets in order to *provide a service to its customers*; brokers trade for their customers as agents, whereas dealers act as the customers' counterparties.

The SEC purports to claim the authority to require that certain hedge funds – as well as potentially numerous other financial market participants – register as dealers, even though, since 1934, those entities have never fallen within the statutory definition. The SEC asserts that this expansion of the dealer regulatory regime is necessary because hedge funds, and other market participants, must be subjected to the dealer regulatory regime to safeguard market liquidity. Separate and apart from exceeding its statutory authority under the Exchange Act, the SEC's economic analysis fails to substantiate that this would in fact be the outcome of the Final Rule. In

fact, by placing additional regulatory burdens on the activity it is supposedly intended to incentivize, the Final Rule is more likely to have the opposite effect.

Dealer registration would subject basic aspects of a hedge fund's operations to significant and costly impediments. In practice, hedge funds will likely significantly curtail those trading activities that the SEC seeks to characterize as "providing liquidity." Yet empirical literature demonstrates that these same trading activities provide significant benefits to U.S. capital markets in the form of price efficiency and lower transaction costs. The Final Rule would therefore produce significant costs by discouraging the very same beneficial trading activity that the SEC purports to safeguard.

The SEC's economic analysis fails to account for these effects of the Final Rule. Specifically, the SEC: (i) asserts that the dealer regulatory regime must be expanded to hedge funds and others to safeguard liquidity but fails to substantiate the existence of any threat to liquidity or market stability from these trading activities; (ii) fails to consider the substantial empirical evidence that hedge fund trading increases price efficiency in U.S. securities markets and to consider how the Final Rule will discourage those trading activities or quantify the costs to U.S. markets that will result; and (iii) utilizes a severely flawed and unreliable methodology to estimate the number of hedge funds affected by the Final Rule. The SEC admits that it cannot estimate the number of market participants affected by one of the rule's two definitional prongs and completely fails to consider the Final Rule's implications for entire asset classes, including with respect to the equity markets. These deficiencies are so fundamental that the SEC has failed to fulfill its statutory obligation under the Exchange Act to "consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation." 15 U.S.C. § 77b(b). The Court must invalidate the Final Rule as "arbitrary, capricious, an abuse of discretion, or otherwise

not in accordance with law" pursuant to Section 706 of the Administrative Procedure Act. 5 U.S.C. § 706.

ARGUMENT

I. The Final Rule is a significant expansion of the dealer regulatory regime.

(i) The Final Rule radically deviates from the SEC's historical interpretation of the statutory definition of "dealer."

The basic function of a broker-dealer is to facilitate its customers' orders in securities markets. The broker-dealer does so by either routing the order to an exchange "for the account" of the customer, in which case it acts as a broker, or by taking the opposite side of the trade and buying or selling the securities from or to the customer for its "own account," in which case it acts as a "dealer." 15 U.S.C. § 78c(a)(4), (a)(5)(A).

Historically, the SEC's interpretation of the "dealer" definition recognized that the defining characteristic of a dealer's business model consists of providing a service to securities market participants—the dealer's *customers*—seeking to buy or sell a security. *See, e.g.*, SEC, Definition of Terms in and Specific Exemptions for Banks, Savings Associations, and Savings Banks Under Sections 3(a)(4) and 3(a)(5) of the Securities Exchange Act of 1934, Exch. Act. Rel. No. 47364, 68 Fed. Reg. 8,686, 8,688 (Feb. 24, 2003), https://www.federalregister.gov/documents/2003/02/24/03-4095/definition-of-terms-in-and-specific-exemptions-for-banks-savings-associations-and-savings-banks; *see also* Commissioner Mark Uyeda, Statement on Further Definition of "As a Part of a Regular Business" in the Definition of Dealer (Feb. 6, 2024) https://www.sec.gov/news/statement/uyeda-statement-dealer-trader-020624 (App. 570) [hereinafter "Uyeda Statement"]; Commissioner Hester Peirce, Dealer, No Dealer?: Statement on Further Definition of "As a Part of a Regular Business" in the Definition

of Dealer and Government Securities Dealer in Connection with Certain Liquidity Providers (Feb. 6, 2024), https://www.sec.gov/news/statement/peirce-statement-dealer-trader-020624 (App. 562) [hereinafter "Peirce Statement"].

By contrast, a firm trading for itself, such as a hedge fund, has never met the statutory definition of dealer. Instead, it buys or sells securities with a view to profiting from changes in the value of the security – that is, buying low and selling high. As this Court recognized, the basic business model of trading for oneself is fundamentally different from that of a dealer; a trader seeks to profit from changes in securities prices, not from pursuit of a regular business of effecting customer orders. *Chapel Invs., Inc. v. Cherubim Ints., Inc.*, 177 F. Supp. 3d 981, 990-91 (N.D. Tex. 2016) (O'Connor, J.) (a person "acting in its own best interests as an investor . . . cannot be considered a dealer").

The Exchange Act and the SEC regulations thereunder subject dealers and government securities dealers to a comprehensive regulatory regime that is oriented toward the goal of customer protection, including registration, risk management, books and records, financial reporting, anti-fraud, and other requirements, *see* 15 U.S.C. § 78o(a), 17 C.F.R. § 240.15c3–5, 15 U.S.C. § 78q, 17 C.F.R. § 240.17a–3, 17 C.F.R. § 240.a–5(d)(1)(i)(A), 15 U.S.C. § 78o(c), as well as the "Net Capital Rule," which requires dealers to maintain liquid assets sufficient to honor all liabilities to the dealer's customers in the event of insolvency, 17 C.F.R. §§ 240.15c3–1, 402.2. This regime has never applied to hedge funds and other market participants, which neither serve customers when they transact in securities markets nor hold themselves out as providing such a service. *See* SEC, Definition of Terms, 68 Fed. Reg. at 8,688. Counterparties of hedge funds and other market participants therefore do not rely on, expect, or need the regulatory protections that the Exchange Act affords customers in the dealer context.

Registered dealers must also become members of a self-regulatory organization ("SRO"), typically the Financial Industry Regulatory Authority ("FINRA"). Dealers must comply with the SRO's rules and are subject to periodic examination by the SRO. 15 U.S.C. § 78o(b). SROs impose additional requirements on dealers, such as the duty of best execution, which requires dealers to "use reasonable diligence" when transacting with their customers to ascertain the best markets for the purchase or sale of a security, so that the resultant price "is as favorable as possible under prevailing market conditions." FINRA Rule 5310, https://www.finra.org/rules-guidance/rulebooks/finra-rules/5310. Dealers must further become members of the Securities Investor Protection Corporation ("SIPC"), which insures dealer customers against the risks of a dealer's insolvency. 15 U.S.C. § 78ccc(a)(2). Government securities dealers must also comply with Department of the Treasury regulations with respect to financial responsibility, capital requirements, recordkeeping, and reports and audits. 17 C.F.R. § 402.2; *see also* Final Rule at 14,967.

As of December 31, 2022, there were 3,378 FINRA-registered dealers. FINRA, 2023 FINRA Industry Snapshot (Aug. 23, 2023), https://www.finra.org/sites/default/files/2023-04/2023-industry-snapshot.pdf. Registered dealers account for a significant proportion of financial markets activities. According to SEC statistics, registered broker-dealers constituted 854 (79%) of the total 1,085 firms active in Treasury markets. *See* Final Rule at 14,968. The SEC does not provide comparable statistics for equity markets.

(ii) *The Final Rule expands the dealer regulatory regime without statutory authorization*.

The Final Rule abandons the essential criterion of serving a customer and introduces a new, amorphous redefinition based solely on the effect of "providing liquidity."

The Final Rule provides that any person is a dealer if that person "engages in a regular pattern of buying and selling securities that has the effect of providing liquidity to other market participants." Final Rule at 15,009. It provides two definitional prongs that would deem a person a dealer if such person (i) "regularly express[es] trading interest that is at or near the best available prices on both sides of the market for the same security and that is communicated and represented in a way that makes it accessible to other market participants," or (ii) "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." *Id.* The Final Rule makes corresponding changes to the definition of "government securities dealer." *Id.* Critically, the Final Rule states that even if a person does not meet either of the foregoing prongs, it may still be acting as a dealer, but provides no criteria for making this determination. *Id.*

The Final Rule's broader definition will require certain hedge funds and other market participants to register and comply with the dealer regulatory regime as a result of their trading activities in U.S. securities markets. The SEC claims that hedge funds and other such non-dealers must be subjected to the dealer regulatory regime to safeguard market liquidity. However, the Final Rule will in fact have the opposite effect on liquidity and thereby produce substantial costs for market participants and investors.

II. The Final Rule will discourage hedge fund trading in U.S. securities markets.

(i) *The Final Rule's criteria are unworkably broad and vague.*

The SEC concedes that the Final Rule's redefinition of dealer is so broad that it could require "all market participants who buy or sell securities" to register as dealers, because all such market participants "arguably contribute to a market's liquidity." SEC, Further Definition of "As a Part of a Regular Business" in the Definition of Dealer and Government Securities Dealer, Exch.

Act Rel. No. 34–94524, 87 Fed. Reg. 23,054, 23,062 (Apr. 18, 2022), https://www.federalregister.gov/documents/2022/04/18/2022-06960/further-definition-of-as-a-part-of-a-regular-business-in-the-definition-of-dealer-and-government (A.R. No. 1). The Final Rule provides specific exclusions for (i) investment companies registered under the Investment Company Act of 1940 (the "1940 Act"); and (ii) central banks. Final Rule at 15,009. The SEC explicitly acknowledges that if it had not included these exclusions, the Final Rule's redefinition of "dealer" would encompass public investment funds, the Federal Reserve, and other central banks, due to their significant securities trading activities. *Id.* at 14,959. But it is not plausible that Congress wrote the Exchange Act's definition of "dealer" knowing that the Federal Reserve would be encompassed and then silently relied on the SEC to exempt the Federal Reserve from dealer registration – 90 years later.

The Final Rule makes no exception for investment funds that are not registered under the 1940 Act, commonly referred to as "private funds," or hedge funds. Indeed, the SEC confirms that the Final Rule would apply to certain hedge funds. *Id.* at 14,970.

The Final Rule's potential application to hedge funds is of critical relevance, because hedge funds account for a substantial portion of trading activity in U.S. securities markets. *See, e.g.*, James Collin Harkrader & Michael Puglia, *Principal Trading Firm Activity in Treasury Cash Markets*, FED. RESERVE (Aug. 4, 2023), https://www.federalreserve.gov/econres/notes/feds-notes/principal-trading-firm-activity-in-treasury-cash-markets-20200804.html. There is a significant body of empirical evidence showing that hedge fund trading activity provides benefits for all securities market participants.

The Final Rule's criteria are so open-ended they appear to sweep in large swaths of the market. For example, the Final Rule provides that a person who provides liquidity by regularly

offering to buy and sell the same security at or near the current market price is a "dealer." Many hedge funds pursue multiple independent trading strategies within the same legal entity that coincidentally result in the purchase and sale of the same security at or around the same time. It would be irrational and inconsistent with the statute to consider these independent strategies together as "dealing." As SEC Commissioner Uyeda has noted, hedge funds also often employ algorithms with strategies that predict the equilibrium market value, buying when the price is below that value and selling when the market price exceeds that value. *See* Uyeda Statement at n.7. The SEC could assert that such strategies are also encompassed in the Final Rule.

The Final Rule is therefore likely to create a chilling effect whereby hedge funds will have to curtail the trading activities that the SEC may potentially assert are dealing under the Final Rule's vague criteria or risk being required to register as dealers.

(ii) *The dealer regulatory framework is incompatible with fundamental aspects of a hedge fund's operations*.

Operating under the dealer regulatory framework is incompatible with basic aspects of a hedge fund's operations. Indeed, there are *no* hedge funds currently registered as dealers, and the Final Rule does not consider how hedge funds could operate effectively as registered dealers.

To offer but one example of the incompatibility, the Net Capital Rule requires dealers to maintain a minimum percentage of liquid assets and subtracts from the calculation of a dealer's liquid assets any so-called "non-permanent" capital that an investor contributes to the dealer and that the investor has the right to withdraw within one year of contribution. 17 C.F.R. § 240.15c3-1(c)(2)(i)(G). The rationale for the Net Capital Rule is to ensure that registered dealers have sufficient liquid assets to meet all customer obligations in the event of the dealer's insolvency. *See, e.g.*, FINRA, 2021 Report on FINRA's Examination and Risk Monitoring Program: Net Capital (Feb. 1, 2021), https://www.finra.org/rules-guidance/guidance/reports/2021-finras-examination-

and-risk-monitoring-program/net-capital. Applying the Net Capital Rule to hedge funds would be disruptive and inappropriate, as such funds do not serve customer counterparties but rather manage portfolios on behalf of advisory clients. Applying the Net Capital Rule to hedge funds will harm investors by placing arbitrary limits on the amounts fund investors may withdraw within certain periods of time. Final Rule at 14,988. The Net Capital Rule will therefore reduce the attractiveness of hedge funds registered as dealers to fund investors. The SEC acknowledges this consequence yet makes no attempt to justify or explain how the agency accounted for this significant negative impact. *Id.* at n.570.

Hedge funds commonly transact as customers of broker-dealers. But if a hedge fund were forced to register as a dealer, it would thereby be excluded from the definition of "customer" and thus lose the customer protections from which it otherwise benefits. *See, e.g.*, Peirce Statement (citing Comment Letter of Comm. on Cap. Mkts. Regul., at 4 (Oct 19, 2022), https://www.sec.gov/comments/s7-12-22/s71222-20146736-312040.pdf). For example, a hedge fund registered as a dealer would lose its "customer" status under Exchange Act Rule 15c3-3, subjecting its assets to the less protective rules for proprietary accounts of a broker-dealer. 17 C.F.R. § 240.15c3-3(a)(1). In addition, the fund would lose the right to advances from SIPC if its carrying broker-dealer suffers a shortfall in customer assets in insolvency. 15 U.S.C. § 78fff-2.

The Final Rule would have the effect of barring hedge funds registered as dealers from investing in initial public offerings ("IPOs"), because registered dealers are prohibited from participating in such offerings. FINRA Rule 5130, https://www.finra.org/rules-guidance/rulebooks/finra-rules/5130. The Final Rule acknowledges this restriction and that "any large-scale exit of hedge funds from this market could impact the ability of issuers to raise new capital," but states merely that under the Final Rule hedge funds will have to choose whether to

register as dealers or forgo investment in IPOs. Final Rule at 14,993. But the SEC offers no conceivable justification for this. The SEC thus again fails to contend with the significant negative effects of the Final Rule and explain why the purported benefits of the rule outweigh the costs. As the SEC has itself acknowledged as part of its repeated efforts to encourage IPOs, IPOs are a critical function of securities markets that provide significant benefits for companies and investors. *See, e.g.*, Chair Gary Gensler, Remarks Before the Healthy Markets Association Conference (Dec. 9, 2021), https://www.sec.gov/news/speech/gensler-healthy-markets-association-conference-120921.

The virtual impossibility of a hedge fund's compliance with the dealer regime will naturally encourage funds to modify their trading activities to fall outside of the SEC's newly discovered meaning of "dealing." Because the Final Rule bases the definition of dealer solely on the effects of their trading activities, hedge funds are likely to curtail precisely those trading activities that have the most beneficial market effects. Reduced hedge fund participation in securities markets, particularly equity and Treasury markets, will produce substantial costs for participants and investors in U.S. markets, which the SEC's economic analysis ignores.

III. The Final Rule's economic analysis is inadequate.

The Exchange Act requires the SEC to consider whether its rulemakings "will" promote the "protection of investors" as well as "efficiency, competition, and capital formation." 15 U.S.C. § 78c(f). Federal courts have interpreted this provision to require the SEC to "determine as best it can the economic implications of the rule it has proposed" by conducting a rigorous and objective economic analysis of its rulemakings. *See, e.g.*, *Chamber of Com. v. SEC*, 412 F.3d 133, 143 (D.C. Cir. 2005). Federal courts have articulated specific criteria for these economic analyses – which are commonly referred to as "cost-benefit analyses" – and have repeatedly invalidated SEC

rulemakings for failing to conduct economic analyses that meet these criteria. *See, e.g.*, *id.*; *see also Am. Equity Inv. Life Ins. Co. v. SEC*, 613 F.3d 166 (D.C. Cir. 2009). The SEC's economic analysis of the Final Rule (the "Economic Analysis") fails to meet several of these criteria.

(a) <u>The Economic Analysis fails to demonstrate the market failure that the SEC claims justifies the expansion of the dealer regulatory regime</u>.

The Fifth Circuit Court of Appeals recently held that SEC economic analyses must substantiate the existence of the problem presented as a primary basis for a rulemaking. *Chamber of Com. v. SEC*, 85 F.4th 760 (5th Cir. 2023). If the SEC asserts the existence of such a problem but fails to show that the problem is "genuine," then the economic analysis is inadequate and the rule must be invalidated. Accurately measuring a rule's economic effects is impossible if the estimated effects are premised on addressing a problem that does not actually exist. *Id.* at 777-78.

The SEC asserts that firms that "provide liquidity" in U.S. securities markets but are not currently registered as dealers threaten "stability" and "liquidity," purportedly because such firms are not subject to the same restrictions on risk-taking as registered dealers. Final Rule at 14,978-79. The SEC asserts that this threat justifies remaking a regulatory category that has existed as part of the U.S. financial regulatory structure for 90 years in order to safeguard liquidity. *Id.*

The SEC presents only two pieces of anecdotal evidence as support for this claim: (i) the 1982 failure of Drysdale Government Securities, a firm that was not a hedge fund; and (ii) the 2020 Treasury market stress, which the SEC suggests was exacerbated by non-hedge fund traders that were not registered as dealers and suddenly ceased providing liquidity in that market. *Id.* at 14,976. In fact, neither example provides any rationale for the Final Rule, let alone with respect to hedge funds.

Drysdale was exempted from registration because it traded exclusively in government securities, which the Exchange Act at the time exempted from dealer registration. *U.S. v. David J.*

Heuwetter, SEC Litigation Release No. 10708, 32 SEC Dkt. 1071, 1985 WL 545686 (Mar. 26, 1985). Congress changed that many years ago. Importantly, Drysdale was involved in "massive securities fraud." *Id.* at *1. The Drysdale example provides no explanation for why, over 40 years later, the dealer regulatory regime now needs to be expanded to broad swaths of market participants that have never met the definition of dealer and, importantly, do not provide services to customers. And as the SEC's Drysdale rationale was contained only in the Final Rule, commenters were not able to respond to it and refute it.

Similarly, the SEC presents no evidence supporting its theory that non-registered dealers, and in particular hedge funds, were responsible for the 2020 Treasury market stress. Instead, the SEC ignored evidence presented in the comment file refuting its characterization of the 2020 market stress. *See, e.g.*, James A. Overdahl, *The SEC's Proposed Rule for Definition of Dealer and Government Securities Dealer*, DELTA STRATEGY GROUP (May 27, 2022), https://www.sec.gov/comments/s7-12-22/s71222-20129910-296081.pdf (A.R. No. 33) [hereinafter "Overdahl Report"].

Scholars have found that hedge funds contribute least to market instability among various types of investors and that hedge funds are distinguished by their ability to withstand rapid and large losses. Monica Billio, Mila Getmansky, Andrew W. Lo & Loriana Pelizzon, *Econometric Measures of Connectedness and Systemic Risk in the Finance and Insurance Sectors*, 104 J. OF FIN. ECON. 535 (June 2012), https://www.sciencedirect.com/science/article/abs/pii/S0304405X11002868. Another study concluded that empirical analyses of the role of hedge funds in financial markets have not demonstrated that hedge funds pose a threat to market stability. Vikas Agarwal & Honglin Ren, *Hedge Funds: Performance, Risk Management, and Impact on Asset Markets*, OXFORD RSCH.

ENCYCLOPEDIA OF ECON. & FIN. (Feb. 22, 2023), https://oxfordre.com/economics/display/10.1093/acrefore/9780190625979.001.0001/acrefore-9780190625979-e-841. The SEC does not address this evidence and ignored evidence presented in the comment file refuting its market stability-based rationale. *See, e.g.*, Craig M. Lewis, *The SEC's Proposed Rules for Further Definition of "As a Part of a Regular Business" in the Definition of Dealer and Government Securities Dealer*, MANAGED FUNDS ASSOC. (Dec. 5, 2022), https://www.sec.gov/comments/s7-12-22/s71222-20152322-320250.pdf (A.R. No. 59) [hereinafter "Lewis Report"].

The SEC attempts to deflect its failure to provide support for its farfetched claims by asserting that "[m]arket participants engaged in dealing activities but without being registered as dealers create the potential for serious externalities if they fail, *regardless of the historical frequency of such failure*." Final Rule at 14,976 (emphasis added). This assertion amounts to an acknowledgement that the Final Rule is based on speculation and not record evidence. This is a violation of the SEC's obligation to measure "as best it can" the economic implications of its rulemakings. Indeed, the Fifth Circuit and D.C. Circuit have already rejected the SEC's reliance on similarly speculative arguments that ignored the actual frequency of the supposed problem the rulemaking was intended to address. *Chamber of Com. v. SEC*, 85 F.4th 760 (5th Cir. 2023); *Bus. Roundtable v. SEC*, 647 F.3d 1144 (D.C. Cir. 2011).

(b) The Economic Analysis fails to consider the economic costs of reduced hedge fund participation in securities markets.

A significant body of empirical evidence demonstrates that the active participation of hedge funds in U.S. securities markets, particularly the equity and Treasury markets, enhances market liquidity and thereby also increases price efficiency, thus benefitting all market participants. By increasing the liquidity of Treasury markets, hedge fund trading benefits American taxpayers by

lowering the cost of government borrowing. This evidence indicates that a reduction in hedge fund participation in these markets could significantly reduce liquidity and price efficiency, resulting in significant costs. Commenters presented evidence of these potential costs to the SEC, but the SEC ignored it. *See, e.g.*, Overdahl Report; Lewis Report. This evidence refutes the SEC's claim that the dealer regulatory regime must be expanded to preserve liquidity and shows that the Final Rule will in fact have the opposite effect. The Economic Analysis, however, does not seek to quantify or even consider this evidence, contrary to the SEC's statutory obligations.

i. Hedge fund trading increases liquidity.

High market liquidity allows market participants to execute trades quickly and at lower cost. Empirical studies show that hedge funds benefit U.S. securities markets, especially in times of stress or low activity. For example, one study examined market liquidity from 1999 to 2013, including a sample of hedge funds managed by 96 different managers. Efe Cotelioglu, Francesco Franzoni & Alberto Plazzi, *What Constrains Liquidity Provision? Evidence from Institutional Trades*, 25 REVIEW OF FIN. 485 (Mar. 2021), https://academic.oup.com/rof/article-abstract/25/2/485/5869448?redirectedFrom=fulltext. The study concluded that the hedge funds increased liquidity in U.S. equity markets and did so to a greater extent than other participants in those markets. *Id.* Other academics measured the extent to which hedge funds supplied or demanded liquidity in U.S. equity markets from 1994 to 2008. Petri Jylha, Kalle Rinne & Matti Suominen, *Do Hedge Funds Supply or Demand Liquidity?*, 18 REVIEW OF FIN. 1259 (July 2014), https://academic.oup.com/rof/article-abstract/18/4/1259/1607281. The study found that hedge funds on net increased market liquidity, particularly in illiquid markets. *Id.*

ii. Hedge fund trading increases price efficiency.

Reduced hedge fund trading therefore also threatens to reduce price efficiency in securities markets.

Efficient prices reflect all available information about a firm, allowing investors to make informed investment decisions based on the true value of the firm, rather than on stale or incomplete information. Efficient prices reduce costs for investors, particularly retail investors, since there is less need to spend money on research and analysis of public information when prices already reflect all relevant information.

Several empirical studies have shown that hedge funds contributed to more efficient pricing by identifying mispriced securities. For example, one study examined the stock holdings and performance of 1,517 hedge funds, including all major hedge funds active in the U.S. equity markets, from 1981 to 2015. Charles Cao, Yong Chen, William N. Goetzmann & Bing Liang, *Hedge Funds and Stock Price Formation*, 74 FIN. ANALYSTS J. 54 (Dec. 12, 2018), https://www.tandfonline.com/doi/abs/10.2469/faj.v74.n3.4. The study concluded that hedge funds were consistently successful in identifying over- and underpriced equity securities, and that hedge funds increased the overall price efficiency of the U.S. equity market. *Id.* Another study compared the trading activity of hedge funds in U.S. equity markets with the trading activity of other institutional investors in the U.S. equity market over the 1982-2014 period. Mustafa Onur Caglayan, Umut Celiker & Gokhan Sonaer, *Hedge Fund vs. Non-Hedge Fund Demand and the Book-to-Market Effect*, 92 J. OF BANKING & FIN. 51 (July 2018), https://www.sciencedirect.com/science/article/abs/pii/S0378426618300943?via%3Dihub. The study concluded that hedge funds were more effective than other institutional investors at identifying mispriced securities. *Id.* A further study analyzed the ability of various classes of

market participants to identify and capitalize on stock price anomalies. Paul Calluzzo, Fabio Moneta & Selim Topaloglu, *When Anomalies Are Publicized Broadly, Do Institutions Trade Accordingly?* 65 MGMT. SCIENCE 4,451 (Oct. 2019), https://pubsonline.informs.org/doi/10.1287/mnsc.2018.3066. The study concluded that hedge funds were most effective at doing so and that hedge funds' identification of mispricings had the effect of increasing price efficiency in the U.S. equity market. *Id.* Other scholars examined hedge fund trading in the U.S. equity market during the 1990-2015 period and found that hedge funds were effective in detecting mispriced stocks during this period. Yong Chen, Zhi Da & Dayong Huang, *Arbitrage Trading: The Long and the Short of It*, 32 THE REVIEW OF FIN. STUDIES 1,608 (Apr. 2019), https://academic.oup.com/rfs/article-abstract/32/4/1608/5086321. Another analysis found that increased investment in hedge funds contributed to faster identification of mispricings and improved price efficiency in the U.S. equity market. Ferhat Akbas, Will J. Armstrong, Sorin Sorescu & Avanidhar Subrahmanyam, *Smart Money, Dumb Money, and Capital Market Anomalies*, 118 J. OF FIN. ECON. 355 (Nov. 2015).

iii. Hedge fund trading in the Treasury market lowers the cost of U.S. government borrowing and strengthens the U.S. economy.

Empirical research shows that trading by hedge funds in the Treasury market leads to lower Treasury yields. A lower yield means that the U.S. government is able to borrow at a lower interest rate. An Office of Financial Research study found that a $41 billion increase in hedge fund Treasury exposure is associated with a 0.062% decline in annual yield for a five-year Treasury note. Ron Alquist & Ram Yamarthy, *Hedge Funds and Treasury Market Impact: Evidence from Direct Exposures* (Working Paper No. 22-05), OFFICE OF FIN. RESEARCH (Aug. 23, 2022), https://www.financialresearch.gov/working-papers/files/OFRwp-22-05-hedge-funds-and-treasury-market-price-impact.pdf. This equates to interest savings of $3.1 million for every $1

billion in U.S. government borrowing. The Treasury market now has $26.9 trillion outstanding. SIFMA, US Treasury Securities Statistics (May 6, 2024), https://www.sifma.org/resources/research/us-treasury-securities-statistics/. A report by the Treasury Department's Borrowing Advisory Committee concludes that by trading Treasury securities, hedge funds increase liquidity in Treasury markets and thereby reduce yields. Treasury Borrowing Advisory Comm., *Explaining the Recent Market Moves Across the Treasury Yield Curve*, U.S. DEP'T OF THE TREASURY (Oct. 31, 2023), https://home.treasury.gov/system/files/221/TBACCharge1Q42023.pdf. A recent analysis by the Committee confirms that hedge fund activity in Treasury markets enables other market participants to invest more easily in Treasuries through futures contracts. COMM. ON CAP. MKTS. REGUL., *An Overview of the Treasury Cash-Futures Basis Trade* (Dec. 20, 2023), https://capmktsreg.org/wp-content/uploads/2023/12/An-Overview-of-the-Treasury-Basis-Trade-12-20-23-FINAL.pdf.

The Economic Analysis fails to consider the extensive evidence presented in the comment file of the benefits of hedge fund activity in equity and Treasury markets, and fails to consider the reduction in these benefits that the Final Rule could produce by discouraging hedge fund participation in equity and Treasury markets.

(c) The Economic Analysis's estimates of the number of affected market participants are fundamentally flawed and unreliable.

The Final Rule's criteria for defining a dealer are so vague and wide-reaching that their intended scope is entirely unclear, making an estimate of the number of affected market participants inherently unreliable. However, the Economic Analysis nonetheless makes two attempts to estimate the number of hedge funds that the Final Rule could require to register as dealers using two separate data sources: (i) reports of Treasury market transactions contained in the TRACE database; and (ii) information about hedge funds' trading strategies drawn from hedge

funds' Form PF filings. Both estimates are fundamentally flawed, including because they completely omit the effect of one of the Final Rule's two definitional prongs. Furthermore, the TRACE-based methodology accounts solely for Treasury market activity and ignores the effect of equity market trading activities. The SEC therefore has no basis on which to measure the extent of the actual costs of the Final Rule, including its adverse impact on market liquidity.

i. The TRACE-based estimate is fundamentally flawed and unreliable.

The Economic Analysis attempts to estimate the number of hedge funds that the Final Rule will require to register as dealers by examining Treasury market transaction data from the TRACE database. The estimate assumes that any hedge fund that traded at least 4 of the 10 highest-volume Treasury securities on at least 15 different trading days in a given month is potentially subject to the Final Rule. The Economic Analysis concludes on this basis that at least 4 hedge funds would be covered by the Final Rule. This estimate methodology is fundamentally flawed.

First, the TRACE-based estimate considers only one of the Final Rule's two prongs. The Final Rule contains two definitional prongs under which the SEC will automatically require a market participant to register as a dealer. The first prong applies to firms that "regularly express trading interest . . . at or near the best available prices on both side of the market for the same security" (the "trading interest" prong). Final Rule at 15,009. The second prong describes firms that "earn[] revenue primarily from capturing bid-ask spreads" (the "bid-ask" prong). *Id.* The SEC states that use of TRACE data only allows it to estimate the number of firms that potentially meet the second prong. As a result, the SEC failed to even hazard a guess regarding the number of firms that potentially meet the trading interest prong. Given the potential breadth of activities covered by the ignored trading interest prong, the SEC's analysis significantly underestimates the number of affected hedge funds.

Second, the SEC states that the level of trading activity used as a proxy for acting as a dealer "may not be necessary or sufficient for determining whether an activity constitutes dealing according to the Final Rules." *Id.* at 14,972. The SEC thus effectively admits that its methodology may not reflect the actual scope of the Final Rule's standard.

Third, the estimate accounts *solely for trading activity in the Treasury markets*. The estimate therefore omits firms that the Final Rule may require to register based on trading in "equities, options or other fixed-income markets" as well as cryptoasset markets. *Id.* at 14,973. These omitted markets, particularly equities markets, account for a substantial portion of trading activities in U.S. capital markets: in 2022, the average daily trading volume in cash Treasuries markets was $614.3 billion. Katie Kolchin, *2023 Capital Markets Fact Book*, SIFMA (July 2023), https://www.sifma.org/wp-content/uploads/2022/07/2023-SIFMA-Capital-Markets-Factbook.pdf. By comparison, average daily volume in U.S. equities markets was $573.1 billion. In fixed income markets it was $299 billion, and over 11 billion options contracts were traded on U.S. exchanges. *Id.* at 56, 60, 65. The TRACE-based estimate thus omits more than 60% of trading activity in U.S. markets. Omitting this trading activity means that the SEC has failed to account for significant costs of the Final Rule.

ii. The Form PF-based estimate is flawed and unreliable.

The Economic Analysis attempts to estimate the number of hedge funds that the Final Rule will require to register as dealers by counting the number of hedge funds that responded affirmatively to a question on Form PF that asks if the fund pursues any "high-frequency trading" ("HFT") strategies. Final Rule at 14,972-73. The SEC concludes on this basis that up to twelve hedge funds could be affected by the Final Rule. *Id.* at 14,973. This attempted estimate is fundamentally flawed.

First, Form PF does not define the term "high-frequency trading." As a result, it is not even clear that an affirmative response to this question has any relation to the activities described in the Final Rule's vague redefinition of dealer. In fact, only two days after the promulgation of the Final Rule, the SEC finalized another rule that deleted the HFT question from Form PF because the SEC determined that the imprecision of the term rendered the resulting data incapable of being used for any useful purpose. *See* CFTC & SEC, Form PF; Reporting Requirements for All Filers and Large Hedge Fund Advisers, Investment Advisers Act Rel. No. IA-6546, 89 Fed. Reg. 17,984 (Mar. 12, 2024), https://www.federalregister.gov/documents/2024/03/12/2024-03473/form-pf-reporting-requirements-for-all-filers-and-large-hedge-fund-advisers. The Economic Analysis's use of a datapoint that the SEC has already identified as not providing any useful market data undermines the basic credibility of the estimates and the Economic Analysis.

Second, the Economic Analysis makes no attempt to determine whether the use of HFT strategies would meet the Final Rule's first or second definitional prong: "[w]e are unable to determine whether the HFT activities that these funds report would satisfy the expressing trading interest factor or the primary revenue factor because we do not observe individual transactions in Form PF." Final Rule at 14,973. Indeed, the Final Rule's redefinition of "dealer" makes no other references to HFT. There is thus little basis for the Economic Analysis to equate the pursuit of an HFT strategy with "dealing activity." Like the TRACE-based estimate, the SEC's Form PF-based estimate is entirely unreliable.

CONCLUSION

The Final Rule departs radically from the SEC's historical interpretation of the Exchange Act's "dealer" definition and the plain meaning of the statute. The SEC's new definition is based solely on the provision of liquidity, even though this is not how a dealer has ever been defined by

Congress or anyone since. The SEC also omits the essential feature that distinguishes brokers and dealers from other securities market participants – the provision of a service to a customer. The SEC claims this expanded definition is necessary because the dealer regulatory regime must now apply to anyone who supplies liquidity to the securities markets in order to safeguard market liquidity. Yet the Final Rule will have the opposite effect.

Specifically, the Final Rule will allow the SEC to assert that any number of hedge funds that actively trade in U.S. securities markets are now required to comply with the regulatory regime for dealers. However, the dealer regulatory regime imposes significant operational impediments that will make it virtually impossible for hedge funds to operate effectively as registered dealers. They are therefore likely to reduce their trading activities to seek to fall outside of the SEC's newly discovered meaning of "dealing."

Reduced hedge fund participation in securities markets threatens to impose significant costs on U.S. investors and the economy more broadly by reducing market liquidity, which the SEC incorrectly claims the Final Rule will safeguard. Notably, the SEC's Economic Analysis completely fails to consider how the Final Rule will discourage hedge fund trading in securities markets and thereby reduce liquidity, or the costs that will result for U.S. markets more broadly. The SEC did not even attempt to estimate accurately the number of market participants that the Final Rule will affect and omitted entirely one of the Final Rule's two definitional prongs from its estimates. The SEC has therefore failed to uphold its statutory obligation to conduct an adequate economic analysis of its rulemakings.

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CERTIFICATE OF SERVICE

I hereby certify that I electronically filed the foregoing using the CM/ECF system on May 7, 2024, which will send an electronic notification of such filing to all counsel of record.

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