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ALERT MEMORANDUM

SEC Adopts New Rules Broadening Dealer Registration Requirements: Private Funds, Principal Trading Firms, and Investment Advisers Take Note

On February 6, 2024, the Securities and Exchange Commission ("**SEC**") finalized rules (the "**Final Rules**")[1] to further define the phrase "as a part of a regular business" as used in the statutory definitions of "dealer" and "government securities dealer" under Sections 3(a)(5) and 3(a)(44) of the Securities Exchange Act ("**Exchange Act**"). "Dealers" must generally register with the SEC and become members of the Financial Industry Regulatory Authority ("**FINRA**"), and they must comply with rules regarding financial responsibility, risk management, transaction reporting, operational integrity, books and records, and more.

The Final Rules expand on the SEC's interpretation of the language "as part of a regular business" by establishing two qualitative standards that will apply to both the "dealer" and "government securities dealer" definitions, and which, if a person satisfies either standard, will require the person to register as either a "dealer" or a "government securities dealer."

The Final Rules, adopted in a 3-2 vote, differ significantly from the proposal (the "**Proposal**"), and remove several of the features from the Proposal that would have potentially required a broader array of persons to register. However, market participants with active large-scale trading operations (including certain hedge funds and principal trading firms) will still need to consider whether their activities now require them to register as dealers or government securities dealers (together, "**dealers**") under the Final Rules.

The effective date is 60 days after publication in the Federal Register, and market participants who now meet the expanded definition are expected to comply within one year from the effective date. Given the time it takes to register as a dealer, market participants will need to prioritize determining whether their activities require them to register as dealers, and, if so, begin the registration process as soon as practicable.

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[1] SEC, *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*, Release No. 34-99477 (Feb. 6, 2024), https://www.sec.gov/files/rules/final/2024/34-99477.pdf (hereinafter, the "Adopting Release").

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The Current "Dealer" Definition and Guidance

Section 3(a)(5) of the Exchange Act defines a "dealer" as "any person engaged in the business of buying and selling securities . . . for such person's own account through a broker or otherwise." However, the definition *excepts* a person that "buys or sells securities . . . for such person's own account, either individually or in a fiduciary capacity, but not as a part of a regular business." Persons that are dealers under the Exchange Act must generally register with the SEC and become members of FINRA. Dealers must comply with a number of SEC and FINRA rules regarding financial responsibility, risk management, transaction reporting, operational integrity, books and records, and more. In addition, persons that are registered as government securities dealers must also comply with the rules of the U.S. Treasury relating to financial condition reporting and risk oversight.

Under both the "dealer" and "government securities dealer" definitions, persons are considered dealers if they are "engaged in the business" of buying and selling securities or government securities for their own account. However, both definitions exclude persons who buy or sell securities "not as a part of a regular business." This is referred to as the "dealer/trader" distinction, and persons that fall on the "trader" side of this line are not considered dealers. The Exchange Act does not define the phrase "regular business," so courts and the SEC have historically looked to certain types of activities as indicative of a person's buying/selling activities being "part of regular business" and therefore requiring registration as a dealer.

Such activities include[2]:

- Underwriting;
- Acting as a market maker or specialist on an organized exchange or trading system;
- Acting as a *de facto* market maker whereby market professionals or the public look to the firm for liquidity; and
- Buying and selling directly to securities customers together with conducting any of an assortment of professional market activities such as providing investment advice, extending credit and lending securities in connection with transactions in securities, and carrying a securities account.

Whether a person is a trader or a dealer can be challenging to determine, and there have been instances where the SEC has alleged that entities that did not believe they needed to register should have registered.[3] There are no bright lines or numerical limits that conclusively qualify someone as a trader rather than a dealer, so market participants must look to various activities that are known "dealer" activities and analogize to their own businesses. The Final Rules offer some additional guidance, but still leave room for the SEC to determine what activities require persons to register as dealers.

The Final Rules

New Rules 3a5-4 and 3a44-2 interpret Sections 3(a)(5) and 3(a)(44) of the Exchange Act, respectively, which provide the definitions of "dealer" and "government securities dealer." The Final Rules provide that a person engaged in buying and selling securities (or government securities) for its own account is engaged in such activity "as part of a regular business" (as the phrase is used in either section of the Exchange Act) if that person

[2] 67 Fed. Reg. 67496 (Nov. 5, 2002); 68 Fed. Reg. 8686 (Feb. 24, 2003).

[3] *See*, *e.g.*, *SEC v. Goldstein*, No. 1:24-cv-20261 (S.D. Fla. filed Jan. 23, 2024) (alleging that the defendants operated as unregistered securities dealers for selling stock of convertible debt instruments); *Keener v. SEC*, Appeal No. 22-14237, (11th Cir. 2022) (appealing the district court's finding that the defendant acted as an unregistered dealer); *Almagarby v. SEC*, Appeal No. 21-13755 (11th Cir. 2021) (appealing the district court's ruling that the defendants were required to be registered as dealers).

engages in a "regular pattern of buying and selling" securities (or government securities) that has the "effect of providing liquidity to other market participants" by either:

1. Regularly expressing 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
2. Earning revenue primarily from capturing bid-ask spreads, by buying at the bid and selling at the offer, or from capturing any incentives offered by trading venues to liquidity-supplying trading interest.

The SEC refers to each of these two items as "factors", though in reality they are standards that are independently sufficient (assuming they have the effect of providing liquidity to other market participants) for determining that a person is a dealer. Each standard includes a number of phrases that must be unpacked to be applied to the activity of a particular market participant.

In the Proposal, the SEC had suggested a third standard that would have been indicative of dealer activity: "routinely making roughly comparable purchases and sales of substantially similar securities in a day. " This standard seemed likely to pick up a wide variety of market participants such as hedge funds and other principal trading firms ("**PTFs**") that may never have thought of themselves as potentially being dealers. The SEC noted the potentially overbroad applicability of this standard in explaining its decision to remove it from the Final Rules, and concluded that the Final Rules are now tailored to "require only entities engaging in *de facto* market making activity to register as dealers." However, the SEC emphasized that the elimination of this standard from the rules "does not mean that conduct that would have been captured by the proposed factor is not dealing activity" and that such activity could also be *de facto* market making under the Final Rules, or could separately constitute dealer activity.[4]

The two standards retained from the Proposal may still require certain market participants to register that previously had not done so, particularly certain hedge funds and other PTFs that employ high-volume trading strategies.

The First Standard: Regularly Expressing Trading Interest

"Regularly expressing trading interest that is at or near the best available prices on both sides of the market for the same security and that are communicated and represented in a way that makes it accessible to other market participants." Rule 3a5-4(a)(1)(i) and Rule 3a44-2(a)(1)(i).

The first standard in the Final Rules is focused on trading activity of market participants. The word "regularly" captures market participants who do not necessarily express trading interest continuously. The SEC explained that expressing trading interest on a one-off basis would not be sufficiently regular to meet the standard, and that in most liquid markets, "regular" would mean more frequent periods of expressing trading interest on both sides of the market, both intraday and across days. Where the market for a security is less liquid, less frequent expressions of trading interest might be considered "regular".

The term "trading interest" is intentionally broader than "quotations" and includes both (i) orders, and (ii) non-firm indications of a willingness to buy or sell a security that identifies the security and at least one of the following: quantity, direction (buy or sell), or price. This includes, then, the various mechanisms market participants use to make markets, or for other purposes, such as streaming quotes, request for quotes (RFQs), or order books.

Importantly, market participants do not need to express trading interest "on both sides of the market" simultaneously in a security to be captured by this

[4] Adopting Release *at* 30-31.

standard. The SEC advised that market participants must look at the totality of their trading activity to determine if they are expressing trading interest on "both sides of the market" for the same security.

Finally, the phrase "accessible to other market participants" means that the market participant must express the trading interest to more than one market participant; however, the SEC stated that the factor "does not hinge on any particular method of communication and representation." Moreover, individual communications to multiple market participants of the same trading interest can meet the standard: "where a person makes a trading interest available (such as streaming two-way indicative quotes) to more than one market participant, even if the person made that trading interest available through individual communications, that person would be expressing trading interest accessible to other market participants."

Hedge funds and other PTFs that use high-volume trading strategies will need to review this standard and the SEC's guidance carefully to determine whether their activities will now result in a dealer registration obligation. The SEC noted in particular that market participants employing "automated, algorithmic trading strategies that rely on high frequency trading strategies to generate a large volume of orders and transactions" would be captured by this standard if they have established themselves as "significant market intermediaries" and "critical sources of liquidity."

The Second Standard: Primary Revenue

> "Earning revenue primarily from capturing bid-ask spreads, by buying at the bid and selling at the offer, or from capturing any incentives offered by trading venues to liquidity-supplying trading interest." Rule 3a5-4(a)(1)(ii) and Rule 3a44-2(a)(1)(ii).

Whereas the first standard focuses on the trading activity of market participants, the second standard focuses on revenue captured from bid-ask spreads, as well as revenues from incentives offered by trading venues, such as maker-taker fees. The use of the term "trading venues" is intended to reach broadly and capture venues such as ATSs or other platforms in addition to exchanges.

In connection with this standard, the SEC explained that the focus is on revenue, rather than profit, as the statutory requirement for being a "dealer" is that a person is "in the business", not that the business is profitable. The SEC further explained that a person that derives the majority of its revenue from the sources described in the Final Rules would satisfy the "primarily" requirement.

Additionally, the SEC expressly noted that there is no exemption or exclusion from this rule for activity with respect to cryptocurrency, digital assets, or distributed ledger technology, explaining that whether a particular activity with respect to securities gives rise to dealer activity requires an analysis of the totality of the facts and circumstances. The Adopting Release notes several times that persons buying and selling securities must consider whether they are a dealer and therefore must register as a dealer, no matter what the specific securities are.

The "Effect of Providing Liquidity" Requirement

In order to be a dealer under either of the two standards in the Final Rules, a person must engage "in a regular pattern of buying and selling securities that has the effect of providing liquidity to other market participants." The SEC spent relatively little time discussing the contours of this requirement in the Adopting Release, and it seems that the standard of activity having the "effect of providing liquidity" will be left to the interpretation of the SEC.

Exclusions

The Final Rules include three exclusions where a person engaged in activities that would otherwise meet the standards:

1. Has or controls total assets of less than $50 million;
2. Is an investment company registered under the Investment Company Act; or

3. Is a central bank, sovereign entity, or international financial institution as defined in Rule 3a5-4(a)(4) and Rule 3a44(a)(4) of the Final Rules.

Despite the requests of commenters, investment advisers, private funds, and hedge funds are not excluded under the Final Rules, meaning their activities can result in the requirement to register if they control more than $50 million in assets and meet one of the standards described above. Furthermore, there is no broad exclusion for non-U.S. entities, meaning that such entities that meet these standards with respect to their U.S. securities activities could also be required to register.

Definition of "Own Account" and Parallel Account Structures; Anti-Evasion Provision

"A person's 'own account' means any account (i) Held in the name of that person; or (ii) Held for the benefit of that person." Rule 3a5-4(b)(2) and Rule 3a44-2(b)(2).

Under the Proposal, a person's "own account" was defined broadly to include accounts held under common control. Notably, while there was a carveout for persons under common control solely due to being clients of a registered investment adviser, the carveout would not have applied if the clients were part of a "parallel account structure" of the investment adviser. This aggregation requirement for parallel account structures could have caused the rules to include many more market participants, both because fewer persons would have been able to take advantage of the exclusion for having assets less than $50 million, and because persons that might themselves not have satisfied any of the standards in the rules could have done so if evaluated collectively.

In response to numerous comments, the SEC amended the definition of "own account" in the Final Rules to a narrower formulation of an account "held in the name of that person" or "held for the benefit of that person. "

While tightening the definition of a person's "own account", the SEC also added an anti-evasion provision in the Final Rules to prevent persons from evading the dealer registration requirements by (1) engaging in activities indirectly that would satisfy the standards in the rules, or (2) disaggregating accounts. This anti-evasion provision is "intended to capture persons dividing or structuring their activity to evade the application of the final rules," and the SEC noted that potentially evasive activity would include:

- Coordinating and integrating trading across commonly controlled groups of legal entities such that it would not meet the qualitative standard, including by switching which legal entity is engaged in trading to evade the "regular" requirement of the qualitative standard;
- Using two legal entities to separately purchase and sell securities; or
- Using several legal entities to purchase and sell securities, but rotating the activity across or among entities in a way that none of the legal entities trades frequently enough to satisfy the "regular" test under either standard.

The SEC explained that a registered investment adviser of separately owned client accounts that follow substantially the same investment objectives and strategies is involved in an ordinary course business activity, and the trading in the client accounts would not be imputed to the adviser's "own account" absent intent to evade the dealer registration requirements. Therefore, investment advisers that utilize parallel account structures in their ordinary course for *bona fide* business reasons should not run afoul of the anti-evasion provisions.[5] The SEC did not provide guidance in the Adopting Release regarding the circumstances under which investment advisers may need to consider

[5] The client accounts themselves, though, would be trading for their "own account". Under the Final Rules, a fund itself (e.g., a hedge fund engaged in *de facto* market making) could be required to register as a dealer, even if the investment adviser advising the hedge fund is not.

whether maintaining ownership interests in their own funds could cause those funds to be considered part of the investment adviser's "own account."

"Government Securities Dealer" Definition

The SEC repeatedly pointed to the U.S. Treasury securities ("**USTs**") market as an impetus for the Proposal and Final Rules, including by citing to a 2020 report from the staff at the Board of Governors of the Federal Reserve[6] estimating that unregistered PTFs account for 61 percent of the total trading activity in USTs on interdealer broker platforms.

In contrast to the Proposal, the Final Rules contain identical standards for persons engaged in activity in government securities such as USTs as for activity in other non-government securities. The Proposal included a "quantitative" standard that would have deemed a person to be acting as a government securities dealer if, as a part of a regular business, that person purchased and sold for its own account, in each of four of the last six calendar months, more than $25 billion of trading volume in government securities. This standard was dropped from the Final Rules, with the SEC concluding that this bright-line test was "unnecessary" given the modified qualitative factors and applicable court precedent.

Compliance and Registration

The compliance date for the Final Rules is one year after the effective date. This gives any person that now meets the definition of "dealer" or "government securities dealer" as a result of the Final Rules just over a year to meet the Exchange Act's registration requirements or cease the activity that would require registration. The process to register as a dealer is burdensome and lengthy, involving registration with the SEC and applying for membership with FINRA. The process can take upwards of six months, even after the new dealer has created the necessary policies and procedures, hired key personnel, had its employees obtain necessary licenses, and prepared, submitted and obtained approval of an application. Moreover, dealer registration can affect a market participant's business in multiple ways including, for example, an inability to participate in IPOs pursuant to FINRA Rule 5130.

Commenters expressed concern that one year did not provide market participants enough time to register, particularly if FINRA begins receiving applications for a large number of new dealers as a result of the Final Rules. This sentiment was echoed by Commissioner Peirce in the Open Meeting, as well as in her remarks dissenting from the rule's adoption.[7] In its own comment letter, FINRA said that it has "ways to help expedite the processing of applications for persons captured by the [Final Rules] and is committed to ensuring an application review process that is thorough and efficient while promoting investor protection." The SEC cited to this comment letter in determining that a one-year compliance period provides sufficient time for affected market participants.

It remains to be seen just how many market participants will now determine that they need to register as dealers, and whether FINRA will indeed be able to handle the influx of applications. Market participants should, therefore, promptly evaluate whether they are dealers under the Final Rules in order to ensure enough time to complete the registration process and meet the compliance deadline.

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[6] James Collin Harkrader and Michael Puglia, "Principal Trading Firm Activity in Treasury Cash Markets," FEDS Notes (Aug. 4, 2020) ("[Principal trading firms] dominate activity on the electronic [interdealer broker] platforms (61%).").

[7] Commissioner Hester Peirce, *Dealer, No Dealer? Statement on Further Definition "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.