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Client Alert | Investment Management

SEC Expands Dealer Definition to Increase Regulation of Liquidity Providers

The U.S. Securities and Exchange Commission (SEC) recently voted 3-2 to adopt Rules 3a5-4 and 3a44-2 (New Rules) under the Securities Exchange Act of 1934 (Exchange Act), as amended, to further define the phrase "as a part of a regular business" as it is used in the statutory definitions of "dealer" and "government securities dealer."[1] Going into effect on April 29, 2024, with implementation one year later, the New Rules significantly expand the definitions of "dealer" and "government securities dealer" (collectively, dealer) to include market participants that engage in the regular purchase and sale of securities with the effect of providing liquidity to other market participants. With the validity of the New Rules facing a recent challenge in federal court, however, it remains to be seen whether they will remain on the books.

Key Takeaways

- Contrary to the SEC's assurance that the New Rules are intended to define the statutory definition of "dealer" and "government securities dealer" narrowly, the New Rules are written to apply broadly to large groups of dealers and government securities dealers that were not previously required to register as dealers.
- Pursuant to the no-presumption clause, the SEC could determine that a person meets the definition of a "dealer" even if that person doesn't fall within either the Expressing Trading Interest Factor or the Primary Revenue Factor.
- Hedge and other private funds that frequently buy and sell securities may trigger the definition of "dealer" under the New Rules.
- Multi-strategy private funds with multiple sub-advisers will likely face significant challenges in determining their dealer status under the New Rules, given the decentralized nature of their trading functions.
- Family offices and other entities exempt from registration under the Investment Advisers Act of 1940, as amended, should also carefully evaluate whether the New Rules apply to them.
- The regulatory consequences for firms captured under the New Rules will be significant. Such firms will have to register as covered dealers under the Exchange Act and become members of the

[1] 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, Rel No. 34-99477 (February 6, 2024), 89 FR 14938 (April 29, 2024) (Adopting Release). (SEC Commissioners Hester Peirce and Mark Uyeda dissenting.)

Financial Industry Regulatory Authority (FINRA). As a result, they also will become subject to many of the same laws and regulations as other broker-dealers. These include, for example, minimum net capital requirements under Rule 15c3-1, comprehensive books and records requirements, extensive records of documented policies and procedures, and audited financial statements. Such firms would also be subject to regulatory oversight and periodic examinations by the SEC and FINRA.

- The New Rules will impose enormous costs on market participants. This includes the direct costs of registering with the SEC and a self-regulatory organization such as FINRA, recordkeeping and reporting costs, and indirect expenses that are incurred as a result of capital monitoring and engaging in an ongoing evaluation as to whether the entity meets the new definition of "dealer." The SEC believes that the New Rules will provide the benefit of subjecting all market participants that perform similar dealer functions to a common regulatory regime. However, it is not clear that the costs outweigh the benefits.
- The SEC confirmed the application of the New Rules to persons engaged in crypto asset securities and refused to carve out an exemption for users and participants in so-called decentralized finance (DeFi) products, structures and activities, including those involving the use of smart contracts, automated market-makers or other "all-to-all" or peer-to-peer execution protocols. Accordingly, such participants must assess whether their activities require registration as a dealer in advance of the compliance date.

Background

Section 3(a)(5) of the Exchange Act defines the term "dealer" to mean "any person engaged in the business of buying and selling securities ... for such person's own account through a broker or otherwise," but excludes a "person that buys or sells securities ... for such person's own account, either individually or in a fiduciary capacity, *but not as a part of a regular business*" (emphasis added). Similarly, the Exchange Act has an analogous definition under Section 3(a)(44) for the term "government securities dealer," also excluding those who do not trade "as a part of a regular business." Market participants often rely on this statutory exclusion, commonly referred to as the "trader" exception, to avoid registration with the SEC.

According to the SEC, market participants in recent years have regularly provided liquidity to the capital markets without registering as dealers under the Exchange Act. The Adopting Release states that this is particularly true in the U.S. Treasury market where certain market participants, particularly those commonly known as proprietary or principal trading firms (PTFs), account for roughly half of the daily volume in the interdealer market, thus performing critical market functions historically performed by registered dealers. While a PTF that is not registered as a dealer may not engage in certain types of dealer activities (e.g., underwriting, soliciting, carrying accounts of others or extending credit), the SEC states that some PTFs act as de facto market-makers without registration as dealers. The SEC asserts that the New Rules are intended to close the regulatory gap in its oversight of market participants for the protection of investors and the markets.

Summary of New Rules

The New Rules significantly expand the definition of "dealer" by establishing two non-exclusive qualitative standards by which a person will be deemed to be engaged in the buying and selling of securities for the person's own account "as a part of a regular business."

Qualitative Standards

Under the New Rules, a person will be deemed to be engaged in a regular pattern of providing liquidity to other market participants "as a part of a regular business" and, thus, subject to registration as a dealer if that person:

- Regularly expresses trading interest that is at or near the best available prices on both sides of the market for the same security and communicates and represents that interest in a way that makes it accessible to other market participants (Expressing Trading Interest Factor).
- Earns 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 (Primary Revenue Factor).

In response to comments, the SEC eliminated a third proposed qualitative standard that would have applied to a person providing liquidity to other market participants by "routinely making roughly comparable purchases and sales of the same or substantially similar securities in a day."[2]

Expressing Trading Interest Factor

Regularly: The SEC also replaced "routinely" with "regularly" under the Expressing Trading Interest Factor, in response to comments that the terms "routine" and "routinely" were unclear and would lead to inconsistent interpretations. The term "regularly" applies to a person's expression of trading interest both within a trading day and over time and is intended to avoid catching persons that only engage in isolated or sporadic expressions of trading interest, as opposed to persons whose regularity of expression of trading interest "demonstrates that they are acting as dealers."[3] The SEC clarified that a market participant does not need to continuously express trading interest to engage in a "regular" business. The SEC noted that such a continuous standard would not be appropriate in markets that exhibit varying degrees of depth and liquidity. Therefore, whether a person's expressions of trading interest are deemed "regular" will depend on the depth and liquidity of the relevant market for a security. For example, in a more liquid market, "regular" may require more frequent expressions of trading interest on both sides of the market, both intraday and across days, given the efficiency with which securities can be bought and sold and the market's ability to absorb orders without significantly impacting the price of the security.[4]

Trading Interest: The term ''trading interest'' means (1) an ''order'' as defined as expressing "any firm indication of a willingness to buy or sell a security, as either principal or agent, including any bid or offer quotation, market order, limit order or other priced order"[5]; and (2) any non-firm indication 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. It is intended to account for the varied mechanisms that permit market participants effectively to make markets, including the use of streaming quotes, quote requests or order books. However, it does not include a market participant seeking price information by requesting quotes on a security, without including prices, on both sides of the market. Accordingly, the Adopting Release clarified that investment advisers' placing of orders or requesting quotations on behalf of their clients would not be activity captured

[2] See Further Definition of "As a Part of a Regular Business" in the Definition of Dealer and Government Securities Dealer, Rel. No. 34-94524 (March 28, 2022), 87 FR 23054 (April 18, 2022) (Proposing Release).

[3] Adopting Release at 14998.

[4] Id. at 14948.

[5] See Rule 3b-16(c) under the Exchange Act.

by the Expressing Trading Interest Factor, unless the investment adviser itself is the account holder or the account is held for the benefit of the investment adviser.[6]

Both Sides of the Market: In order to come within the Expressing Trading Interest Factor, expressions of trading interest must be at or near the best available prices "on both sides of the market" for the same security. However, the Adopting Release clarified that this requirement is not limited to simultaneous expressions of trading interest on both sides of the market.[7] Instead, market participants will need to assess the totality of their trading activity to determine if they are expressing trading interests on both sides of the market for the same security sufficiently close in time to have the effect of providing liquidity in the same security to other market participants.

Accessible to Other Market Participants: The phrase ''accessible to other market participants'' means that a person must express trading interests to more than one market participant. In addition, the expression of trading interest does not depend on any particular method of communication or representation. Again, whether a person is expressing trading interest to other market participants depends on the totality of the trading activity.

Primary Revenue Factor

According to the SEC, one fundamental characteristic typical of dealer activity is trading in a manner designed to profit from bid-ask spreads or liquidity incentives rather than seeking compensation attributable to changes in the value of securities traded. Such persons are ''in the business'' of providing liquidity because (1) they routinely supply liquidity and (2) the revenue they earn through bid-ask spreads or liquidity incentives is their primary source of revenue.[8]

Earn Revenue: The SEC determined to keep the phrase "earn revenue" rather than "earn profit," as some commenters had suggested. The Adopting Release explains that dealer status requires only that a person be ''in the business,'' not that such business be profitable.[9]

Trading Venue: The term "trading venue" is intended to capture the variety of venues in which market participants today engage in liquidity-providing activity, as well as venues as they evolve, wherever the activity occurs. Therefore, rather than focusing on a particular venue, the term is keyed to whether a market participant provides liquidity for that venue. As the Adopting Release explains, "[t]he "term 'trading venues' is designed to help ensure that, as innovation and technology used by such venues evolve, the final rules remain effective at supporting market stability and resiliency, protecting investors and promoting competition across the U.S. Treasury and other securities markets."[10]

Primarily: The term "primarily" is satisfied if a person derives the majority of revenue from bid-ask spreads or liquidity incentives rather than with a view toward appreciation in

[6] Adopting Release at 14950.

[7] Id. at 14951.

[8] Id. at 14952.

[9] Id. at 14954.

[10] Id.

value.[11] On the other hand, a person that regularly earns more revenue from appreciation in the value of such person's inventory of securities than from capturing bid-ask spreads or incentive payment for liquidity provision is less likely to be considered to earn revenue "primarily" from capturing bid-ask spreads or trading incentives.[12]

Definition of 'Own Account' and Anti-Evasion
The Exchange Act defines a "dealer" and "government securities dealer" as a person engaged in the business of buying and selling securities for such person's "own account." The New Rules define "own account" to mean an account: (1) held in the name of that person or (2) held for the benefit of that person.

The SEC also included an "anti-evasion provision" that prohibits persons from evading registration by (1) engaging in activities indirectly that would satisfy the qualitative factors or (2) disaggregating accounts.

The No-Presumption Clause
The SEC also adopted, as proposed, a "no presumption" clause that clarifies that a person may be a "dealer" if such person engages in a regular business of buying and selling securities for their own account, even if it does not meet the conditions set forth in the New Rules. As the SEC explained in the Proposing Release, the New Rules "would not seek to address all persons that may be acting as dealers or government securities dealers under otherwise applicable interpretations and precedent."[13] A person that does not meet the conditions set forth in the New Rules may nonetheless be a dealer if such person is otherwise engaged in a regular business of buying and selling securities for that person's own account by, for example, acting as an underwriter. The Adopting Release also reiterates that the New Rules do not modify existing court precedent and SEC interpretations, which continue to apply to determine whether a person is a dealer, even if such person would not qualify under the New Rules.

Exclusions
The New Rules exclude certain market participants that the SEC determined do not provide liquidity to the markets in a manner requiring dealer registration or are subject to a comparable regulatory structure that addresses the type of concerns intended for the New Rules to address. Specifically, the New Rules exclude:

- Registered investment companies under the Investment Company Act of 1940.
- Persons that have or control less than $50 million in total.
- Central banks, sovereign entities and international financial institutions.

However, the SEC determined not to exclude private funds, registered investment advisers or crypto asset firms despite comments suggesting additional exclusions.

Investment advisers who trade on behalf of their clients, including those who have discretionary authority under separately managed accounts, will not be captured by the New Rules because they would not meet the definition of buying and selling for "their own account."

[11] Id.

[12] Id.

[13] See Proposing Release at 23077.

Compliance Date
The New Rules will be effective on April 29, 2024. Persons covered under the New Rules will have until April 29, 2025, to come into compliance and complete their dealer registration with the SEC and Financial Industry Regulatory Authority (FINRA).

Recent Challenge to Validity

Three trade associations, whose members are private funds managers, filed a complaint March 18 in the U.S. District Court for the Northern District of Texas, Fort Worth Division, challenging the SEC's adoption of the New Rules.[14] The complaint, *National Association of Private Fund Managers v. SEC*, alleges that the New Rules exceed the SEC's statutory authority, are arbitrary and capricious, and violate the Exchange Act by imposing a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act. The complaint requests, among other things, that the court vacate and set aside the New Rules in their entirety and enjoin the SEC from implementing them.

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[14] *National Association of Private Fund Managers v. SEC*, No. 4:24-cv-00250 (N.D. Tex. filed March 18, 2024) (Complaint).