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CLIENT ALERT

SEC to Require Some Proprietary Trading Firms and Private Funds to Register as "Dealers"

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On February 6, 2024, the U.S. Securities and Exchange Commission ("SEC") adopted new Rules 3a5-4 and 3a44-2 under the Securities Exchange Act of 1934 (the "Exchange Act") that effectively broaden the scope of persons considered to be "dealers" or "government securities dealers."[1] Proprietary trading firms and private funds that are deemed dealers or government securities dealers under the rules will face significant impacts. They will be required to register with the SEC and FINRA, become subject to the Exchange Act and SEC and FINRA rules (e.g., net capital requirements),[2] and subject to examination and investigations by the SEC and FINRA. The compliance date for the new rules is 12 months from the effective date, which is 60 days after publication in the Federal Register.

Dealers/Government Securities Dealers

Section 3(a)(5)(A) of the Exchange Act defines a "dealer," in relevant part, as "any person engaged in the business of buying and selling securities . . . for such person's own account through a broker or otherwise." Section 3(a)(5)(B) excludes from the definition of dealer, "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."

1 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, Securities Exchange Act Release No. 99477 (Feb. 6, 2024) ("Adopting Release").

2 Firms that are government securities dealers (including registered broker-dealers trading government securities) must also comply with rules adopted by the U.S. Treasury, including rules relating to financial responsibility, recordkeeping, financial condition reporting, and risk oversight.

Similarly, Section 3(a)(44) of the Exchange Act defines a "government securities dealer" as, in relevant part, "any person engaged in the business of buying and selling government securities for his own account, through a broker or otherwise," but "does not include any person insofar as he buys or sells such securities for his own account, either individually or in some fiduciary capacity, but not as part of a regular business."

The New Rules

Rules 3a5-4 and 3a44-2 will expand the circumstances under which a person is deemed to be engaged in dealing activity or government securities dealing activity "as part of a regular business." Under the new rules, a person who buys and sells securities for its own account is engaged in such activity "as part of a regular business" if that person "[e]ngages in a regular pattern of buying and selling securities that has the effect of providing liquidity by" satisfying at least one of two qualitative factors: the Expressing Trading Interest Factor or the Primary Revenue Factor. The SEC stated that when the frequency and nature of a person's securities trading is such that the person assumes a role—whether described as market-making, de facto market-making, or liquidity-providing—similar to the role that historically has been performed by a registered dealer, that person would be deemed to be a dealer or government securities dealer.[3]

Expressing Trading Interest Factor

The Expressing Trading Interest Factor looks to whether a 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 that is communicated and represented in a way that makes it accessible to other market participants. The SEC stated that the Expressing Trading Interest Factor captures the hallmark de facto market making activity in which dealers make a market in a security by standing ready to trade on both sides of the market with respect to the same security on a regular, ongoing basis. According to the SEC, the Expressing Trading Interest Factor would capture market participants that have established themselves as significant market intermediaries—and critical sources of liquidity—in a market by employing automated, algorithmic trading strategies that rely on high frequency trading to generate a large volume of orders and transactions, including market participants that, for example, employ passive market making strategies involving the submission of non-marketable resting orders (bids and offers) that provide liquidity to the marketplace at specified prices.[4]

Regularly. The SEC stated that the term "regularly" applies to a person's expression of trading interest both within a trading day and over time, and distinguishes persons engaging in isolated or sporadic expressions of trading interest from persons whose regularity of expression of trading interest demonstrates that they are acting as dealers. A market participant does not need to be continuously expressing trading interest to be engaging in a regular business.[5] The SEC identified liquidity and depth of the relevant market for the security as a factor in determining whether a person's activity is regular. On the

[3] Adopting Release at 27.

[4] *Id.* at 37

[5] *Id.* at 36.

one hand, the SEC stated that in markets that have significant liquidity and market depth, and have experienced advancements in technology and electronic trading (e.g., the U.S. Treasury market), expressing trading interest on both sides of the market for the same security as part of an investment strategy on a one-off basis would not be sufficiently regular, and that “regular” in the most liquid markets would mean more frequent periods of expressing trading interest on both sides of the market both intraday and across days given the efficiency in which securities can be bought and sold and the market’s ability to absorb orders without significantly impacting the price of the security. On the other hand, for less liquid markets where it is difficult to execute orders in that security or large orders can dramatically affect the price of the security, the term regular would account for the possibility of more interruptions or wider spreads for the best available prices.[6]

Trading Interest. The SEC described “trading interest” as (i) an “order” as the term is defined in Exchange Act Rule 3b-16(c); or (ii) 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.[7] The term “trading interest” captures a variety of mechanisms that permit market participants to effectively make markets, including, but not limited to, the use of streaming quotes, request for quotes (“RFQs”), or order books.[8] This new concept of expressing trading interest “that is at or near the best available prices on both sides of the market for the same security” is a broader concept than providing two-sided quotes at or near the best bid or offer. Expressing trading interest depends less on the method used to communicate trading interest, and more on whether the person is expressing trading interest on both sides of the market for the same security that has the effect of providing liquidity in the same security to other market participants. In addition, a market participant seeking price information by requesting quotes on a security, without including prices, on both sides of the market would generally not satisfy this qualitative factor because that trading interest, absent more, would not be “at or near the best available price.”[9]

Both Sides of the Market. Trading interest does not have to be expressed simultaneously on both sides of the market. According to the SEC, while simultaneously expressing trading interest on both sides of the market in the same security is indicative of dealer activity, market participants also can be acting as dealers by regularly providing liquidity even when the expressions of trading interest on both sides of the market for the same security are not simultaneous, particularly because the markets for different securities have varying structures, trading volume, and liquidity. The SEC stated that, due to the differences between markets, 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. Further, the SEC believes that it will be possible to assess whether a non-firm trading interest is actually “at or near the best available price,” using the similar information that

[6] *Id.* at 36–37.

[7] *Id.* at 38.

[8] *Id.* at 41.

[9] *Id.* at 41–42.

market participants use to make bids and offers, including recently completed purchases and sales and the totality of indications of willingness to buy or sell at specified prices.[10]

Accessible to Other Market Participants. The SEC stated that the phrase "accessible to other market participants" reflects the plain meaning that a person expresses trading interests to more than one market participant. For example, 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, the SEC believes that person would be expressing trading interest accessible to other market participants. The SEC stated that this does not turn on any particular method of communication and representation (e.g., RFQ, indications of interest, or streaming quotes) but rather the totality of the trading activity.[11]

Primary Revenue Factor

The Primary Revenue Factor looks to whether a person 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. The term "trading venues" is intended to accommodate the variety of venues in which market participants today engage in liquidity-providing dealer activity (e.g., national securities exchanges, ATSs, broker- or dealer-operated platforms for executing trading interest internally by trading as principal or crossing orders as agent, and other platforms performing similar functions), as well as trading venues that use technologies and venues that may develop over time.[12]

"Primarily" looks to whether a person derives the majority of its revenue from the sources described in the Primary Revenue Factor. The SEC stated that it is unlikely that a person who regularly earns more revenue from other sources, such as an appreciation in the value of its inventory of securities or revenue from interest, and not from capturing bid-ask spreads or incentive payment for liquidity provision, would be considered to earn revenue "primarily" from capturing bid-ask spreads or trading incentives. According to the SEC, one fundamental and historically recognized view of dealer activity is trading in a manner designed to profit from spreads or liquidity incentives. Under the final rules, persons providing liquidity because they regularly supply it and the revenue they earn as a result through bid-ask spreads or liquidity incentives as their primary source of revenue are "in the business" of dealing, and such persons regularly undertaking this liquidity providing role for their own account in overall trading and market activity must register as dealers and be subject to the dealer regulatory regime.

[10] *Id.* at 46–48.

[11] *Id.* at 49.

[12] *Id.* at 56–57.

Deletion of Other Proposed Qualitative Standard

Notably, the SEC did not adopt its third proposed qualitative standard, "routinely making roughly comparable purchases and sales of the same or substantially similar securities in a day." The SEC agreed with commenters that this standard could have captured more trading activities than intended by the new rules, but nonetheless emphasized that the elimination of this factor does not mean that the conduct that would have been captured is not dealing activity, and that this conduct may be de facto market making under the Expressing Trading Interest Factor or the Primary Revenue Factor or dealer activity under otherwise applicable precedent.[13]

Deletion of Proposed Quantitative Standard

The SEC proposed a quantitative standard for purposes of determining whether a person would be deemed a government securities dealer that would have provided that a person engaged in buying and selling government securities for its own account would be engaged in such activity "as a part of a regular business" if that person in each of four out of the last six calendar months, engaged in buying and selling more than $25 billion of trading volume in government securities as defined in Section 3(a)(42)(A) of the Exchange Act. The SEC determined that this bright line test was unnecessary and that the modified qualitative factors and otherwise applicable court precedent and SEC interpretations will appropriately address when market participants are acting as government securities dealers in the U.S. Treasury market by engaging in a "regular" pattern of buying and selling securities that has the effect of providing liquidity to other market participants.[14] The SEC's deletion of the two proposed standards are welcome changes from the proposed rules and, hopefully, will meaningfully narrow the scope of persons who are within scope of the final rules.

Definition of "Own Account"

The final rules define "own account" to mean an account: (i) held in the name of that person; or (ii) held for the benefit of that person. The SEC stated that the rules as adopted thus are consistent with the SEC's historical "entity" approach to broker-dealer regulation. In response to concerns raised by commenters related to, among other things, the breadth of the proposed rule's aggregation approach, the SEC determined to focus, subject to the anti-evasion provision discussed below, on an analysis of activity on an entity-by-entity basis, rather than aggregating accounts across entities that are controlled by or are under common control with an entity.[15]

[13] *Id.* at 30–31.

[14] *Id.* at 61.

[15] *Id.* at 21, 88.

Anti-Evasion Provision

The final rules include two anti-evasion provisions that are intended to deter the establishment of multiple legal entities or accounts to evade appropriate regulation. One provision prohibits a person from evading dealer or government securities dealer status by engaging indirectly in activity that would meet one of the qualitative standards. The SEC stated that this prong would prohibit a person from using a third party to indirectly engage in activity that would meet the qualitative standard.[16] The other anti-evasion provision prohibits evading dealer or government securities dealer status by disaggregating accounts, meaning separating or breaking up accounts. The SEC stated that this prong is intended to prevent a person from seeking to evade the final rules by spreading activity across entities or accounts while maintaining the same overall trading levels. The SEC did not intend this to limit the ordinary course business activities of persons who have no evasion intent or purpose. For instance, the SEC would generally consider management by a registered investment adviser of separately owned client accounts that follow substantially the same investment objectives and strategies to be ordinary course business activities, and so would not impute the trading in the clients’ accounts to the adviser’s “own account,” absent intent to evade the dealer registration requirements.[17] Similarly, because advising multiple client accounts generally should be considered ordinary business activities, separate client accounts, even with substantially the same investment objectives and strategies, should not need to be aggregated for purposes of the final rules.

The SEC described potentially evasive activity as including, but not being limited to, coordinating and integrating trading across commonly controlled groups of legal entities (e.g., including by switching which legal entity is engaged in trading); 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 the Expressing Trading Interest Factor or the Primary Revenue Factor. The SEC stated that, in determining whether a person is violating the anti-evasion provision, it might consider whether there are: information barriers to prevent sharing of information or sufficiently segregated trading; overlapping personnel across accounts or entities; or separate account statements for each account. The SEC might also look to whether there are personnel with oversight or managerial responsibility over multiple accounts in a single entity or affiliated entities, and account owners of multiple accounts, that do not have authority to execute trades or pre-approve trading decisions for accounts or entities; or a business purpose that demonstrates that there is no coordinated buying and selling between accounts or entities.[18]

[16] *Id.* at 90.

[17] *Id.* at 91.

[18] *Id.* at 91–92.

No Presumption Clause

The final rules provide that no presumption shall arise that a person is not a dealer within the meaning of section 3(a)(5) or 3(a)(44) of the Exchange Act solely because the person would not be deemed a dealer under the rules. The SEC reiterated that the final rules do not modify existing court precedent and Commission interpretations, which continue to apply to determine whether a person is a dealer, even if such person would not qualify as a dealer under the final rules.[19]

Exclusions

The final rules exclude from their application (1) any person that has or controls total assets of less than $50 million;[20] (2) investment companies registered under the Investment Company Act of 1940; (3) central banks, (4) sovereign entities, and (5) international financial institutions.

Private Funds and Registered Investment Advisers

The SEC did not exclude private funds or registered investment advisers from Rules 3a5-4 or 3a44-2. The adopting release notes that facts and circumstances may indicate that a private fund or investment adviser may be engaged in the business of buying and selling securities for its own account. According to the SEC, if such entities are engaged in dealing activity, they should be subject to the dealer regulatory regime. In response to commenters who stated that private funds are merely pools of assets that rely on fund managers for all functions and therefore do not have personnel or infrastructure to meet the dealer regulatory requirements, the SEC stated that a private fund that engages in activities that trigger dealer registration under the final rules would need to establish means, whether by contract or otherwise, of complying with the obligations for registered dealers, just as the private fund must do to comply with any other regulatory obligation.[21]

Crypto Asset Securities and Decentralized Finance ("DeFi")

The SEC also did not exclude crypto and DeFi from the final rules. The SEC stated that, whether a particular activity in the crypto asset securities market, including in the DeFi market, gives rise to dealer activity requires an analysis of the totality of the particular circumstances against all elements of the Expressing Trading Interest Factor.[22]

Conclusion

The SEC estimated that the final rules would only impact approximately 43 entities. In light of uncertainties with respect to several key terms in the final rules, it is possible that a wider range of firms could be impacted or may decide to register as

[19] *Id.* at 93.

[20] Such a person could potentially be a dealer under existing SEC and SEC staff guidance.

[21] Adopting Release at 69–71.

[22] *Id.* at 43.

dealers rather than face second-guessing by the SEC or a court that their activities satisfied the vague qualitative standard. For example, the lack of a definition of the term "regularly" leaves significant room for interpretation as to what level of activity is sufficiently regular to bring a market participant within scope of the final rules. Similarly, it is not clear how close in time expressions of trading interest need to be for a market participant to be deemed a dealer, or what time periods should be used in determining whether a person receives a majority of its revenue from the sources described in Primary Revenue Factor. It is hard to reconcile the final rules with the SEC's historical approach to defining a dealer for purposes of the federal securities laws. The SEC has long identified factors that would be informative for determining whether a person is a dealer. For example, in 2002, the SEC stated:

> A person generally may satisfy the definition, and therefore, be acting as a dealer in the securities markets by conducting various activities: (1) underwriting; (2) acting as a market maker or specialist on an organized exchange or trading system; (3) acting as a de facto market maker whereby market professionals or the public look to the firm for liquidity; or (4) 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.[23]

The final rules appear to go well beyond any prior SEC interpretations of dealer status and raise significant interpretive issues for firms that are concerned that they might be covered.

While the SEC was clear in the adopting release that it is focused on requiring what it views as de facto market makers to register as dealers because they provide liquidity, historically, the SEC took the position that providing liquidity by itself is not sufficient to make a person a market maker. Section 3(a)(38) of the Exchange Act, which is nowhere referenced in the adopting release, defines a market maker, in relevant part, as "any dealer who, with respect to a security, holds himself out (by entering quotations in an inter-dealer communications system or otherwise) as being willing to buy and sell such security for his own account on a regular or continuous basis." The "holding out" and regular/continuous participation elements distinguish a market maker from a dealer. Through its qualitative factors, the SEC has now effectively created a new, parallel definition of market maker. It will be interesting to see whether the SEC seeks to use this new "expressing trading interest" construct to broaden the scope of what it means for a person to hold out as being willing to buy and sell a security for purposes of being deemed a market maker.

Finally, it is unclear what entity would be required to register under the final rules, particularly for private funds that are in scope. As the definition of dealer looks to the person that is engaging in activity, one might expect that private funds themselves, and not the private fund adviser, would be required to register. Private funds, however, typically are not

[23] Definition of Terms in and Specific Exemption for Banks, Savings Associations, and Savings Banks Under Sections 3(a)(4) and 3(a)(5) of the Securities Exchange Act of 1934, Exchange Act Release No. 46745 (Oct. 30, 2002), 67 FR 67496, 67498-67500 (Nov. 5, 2002).

organized in a manner that would allow for registration (e.g., they do not have personnel). Moreover, private funds that are required to register will need to grapple with difficult reporting issues related to direct and indirect owners and other issues on Form BD.

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