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Legal Update

SEC Rule Proposal Seeks to Clarify "Dealer" Definition for Persons Engaging in Liquidity-Providing Activities

Proposed Rules Could Require Dealer Registration by Certain Principal Trading Firms, Private Funds, Investment Advisers and Other Market Participants

On March 28, 2022, the U.S. Securities and Exchange Commission ("SEC") proposed two new rules – SEC Rules 3a5-4 and 3a44-2 (the "Proposed Rules") – that would further define the phrase "as part of a regular business" in the definitions of "dealer" and "government securities dealer" in Sections 3(a)(5) and 3(a)(44) of the Securities Exchange Act of 1934 (the "Exchange Act"), respectively, requiring persons engaging in such activities, absent an available exception or exemption, to register as a dealer or government securities dealer pursuant to Sections 15(b) or 15C(a) of the Exchange Act.[1]

Specifically, the Proposed Rules would establish three (3) qualitative standards designed to require registration of market participants who engage in a *routine pattern* of buying and selling securities or government securities for their own account that has the *effect of providing liquidity to other market participants*. In addition, proposed SEC Rule 3a44-2 would establish a bright-line quantitative standard under which a person engaging in specified levels of trading activity in U.S. Treasury Securities (as defined below) would be deemed to be buying and selling such securities as a "regular business," regardless of whether such person meets any of the qualitative standards. Moreover, as further described below, to account for variations in corporate structure and ownership, the Proposed Rules would define the terms "own account" and "control."

In light of advances in electronic trading, changes in market structure and the significant liquidity-providing role of certain market participants, particularly principal or proprietary trading firms ("PTFs"), that are currently not registered as dealers or government securities dealers, the SEC believes that the registration of these market participants as dealers or government securities dealers would provide regulators with a more comprehensive view of the markets through regulatory oversight and would enhance market stability and investor protection. To that end, the Proposed Rules would require registration of *any market participant* that comes within their reach, absent an exemption or exception, including many that historically have not been viewed as acting in a dealer capacity. Indeed, beyond PTFs, a variety of market participants would likely come within the scope of the Proposed Rules, including certain private funds, registered investment advisers and entities engaging in digital asset securities activities.

The SEC is requesting comments on the Proposed Rules no later than May 27, 2022.

Background

Section 3(a)(5) of the Exchange Act generally defines the term "dealer" as 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*. This statutory exclusion from the "dealer" definition is often referred to as the "trader" exception or the "dealer/trader distinction." Section 3(a)(44) of the Exchange Act establishes a nearly identical definition of the term "government securities dealer" with respect to activities in government securities.

The Exchange Act does not define what it means to be engaged in a "regular business," but courts and the SEC generally assess the frequency and nature of the trading activity in determining whether a person is engaged in the business of buying and selling securities for its own account as part of a "regular business." In this regard, the SEC and the courts have identified and applied certain factors, including acting as a market maker, de facto market maker or liquidity provider, to distinguish between traders and those engaged in a "regular business" of buying or selling securities for their own account – *i.e.*, those acting as a dealer. The Proposed Rules would further expand on existing interpretations and precedent by more specifically identifying activities of market participants who assume dealer-like roles and whose trading activity has the effect of providing liquidity to other market participants.

Proposed Rules

Proposed SEC Rules 3a5-4 and 3a44-2 would build upon the statutory definitions of "dealer" and "government securities dealer" by further defining which buying and selling activities for one's own account constitute a "regular business." Absent an exception or exemption (*e.g.*, certain exemptions for foreign broker-dealers, such as, with respect to registration of "dealers," those in SEC Rule 15a-6), a person[2] engaged in the activities set forth in the Proposed Rules, as described below, would be required to register as a "dealer" or "government securities dealer" under the Exchange Act. Notably, the Proposed Rules focus on the *effect* of a person's trading activity in providing liquidity to other market participants, where such liquidity provision is not merely incidental to the person's trading activity, *whether or not that effect is intended*.

Importantly, the Proposed Rules would not be the exclusive means for determining whether a person is acting as a dealer or government securities dealer as defined under the Exchange Act. Existing SEC guidance regarding dealer and government securities dealer status will continue to apply to the extent consistent with the Proposed Rules.[3]

QUALITATIVE STANDARDS – APPLICABLE TO DEALERS AND GOVERNMENT SECURITIES DEALERS

The Proposed Rules would provide that a person is engaged in buying and selling securities for its own account "as part of a regular business" if that person engages in a *routine pattern* of buying and selling "securities" or "government securities" (as such terms are defined in Sections 3(a)(10) and 3(a)(42)(A) of the Exchange Act – this would also include digital asset securities that are "securities" or "government securities") that has the *effect of providing liquidity to other market participants* by:

(i) Routinely making roughly comparable purchases and sales of the same or substantially similar securities (or government securities) in a day;

(ii) Routinely expressing trading interests that are at or near the best available prices on both sides of the market and that are communicated and represented in a way that makes them accessible to other market participants; or

(iii) 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 interests.

A person who meets any one of the three qualitative standards would be considered a dealer or government securities dealer under the Proposed Rules and, therefore, be required to register as such.

Routinely making roughly comparable purchases and sales of the same or substantially similar securities in a day

The term **"routinely"** means more frequent than occasional but not necessarily continuous, "such that a person's transactions in roughly comparable positions, throughout the day and routinely over time, constitute '[engaging] in a routine pattern of buying and selling securities that has the effect of providing liquidity for market participants' under the Proposed Rules."[4] According to the SEC, "routinely" is intended to "separate persons engaging in isolated or sporadic securities transactions from persons whose regularity of participation in securities transactions demonstrates that they are acting as dealers."[5] For these purposes, the SEC notes that "more frequent buying and selling is indicative of dealer activity."[6]

"Roughly comparable" is intended to "capture purchases and sales that are similar enough, in terms of dollar volume, number of shares, or risk profile, to permit liquidity providers to maintain near market-neutral positions by netting one transaction against another transaction."[7] Purchases and sales would be "roughly comparable" if they "fall within a reasonable range that generally would have the effect of offsetting one transaction against the other."[8] The SEC would view a person that closes or offsets the "overwhelming majority" of the positions it has opened within the same day to likely have made roughly comparable purchases and sales.[9] The SEC requests comment on whether the Proposed Rules should include a specific threshold for determining when purchases and sales are "roughly comparable," such as a daily buy-sell imbalance below 20%, in terms of dollar volume.

With respect to the phrase **"same or substantially similar"** securities, securities are the "same" if the securities are of the same class and have the same terms, conditions and rights (*e.g.*, securities with the same CUSIP number). Determining whether securities are "substantially similar" would be based on the facts and circumstances and take into account factors such as whether: (i) the fair market value of each security primarily reflects the performance of a single firm or enterprise or the same economic factor or factors, such as interest rates; and (ii) changes in the fair market value of one security are reasonably expected to approximate, directly or inversely, changes in, or a fraction or a multiple of, the fair market value of the second security.

Routinely expressing trading interests that are at or near the best available prices on both sides of the market and that are communicated and represented in a way that makes them accessible to other market participants

The term **"routinely"** as used in this standard is intended to have the same meaning as in the first qualitative standard above.

"Trading interest" would include an "order," as defined in SEC Rule 300(e) of Regulation ATS, and "any non-firm indication of a willingness to buy or sell a security that identifies at least the security and either quantity, direction (buy or sell), or price."[10] This proposed definition of "trading interest" is aligned to the definition of the same term in the SEC's recently proposed amendments to Regulation ATS (specifically, proposed SEC Rule 300(q)),[11] and captures "the traditional quoting engaged in by dealer liquidity providers, new and developing quoting equivalents, and the orders that actually result in the provision of liquidity that the Commission intends the Proposed Rules to address."[12]

A market participant must both buy and sell securities to come within the scope of this qualitative standard. The SEC does not provide guidance on the meaning of the phrases "best available prices on both sides of the market" or "communicated and represented in a way that makes them accessible to other market participants," such as how the SEC expects this qualitative standard to apply across different types of securities (such as equity, fixed income and digital asset securities) or trading practices typical in each of these markets.

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 interests

This qualitative standard is intended to capture market participants engaging in purchase and sale transactions *designed to profit* from bid-ask spreads or liquidity incentives (*i.e.*, incentives offered by trading venues to liquidity-supplying trading interests), rather than changes in the value of the securities traded. Although the Proposed Rules do not provide a bright-line threshold for determining whether a market participant's revenue is made up **"primarily"** from capturing bid-ask spreads or liquidity incentives, or a combination of the two, the SEC believes a person likely would come within the scope of this qualitative standard if it derives the "majority" of its revenue from these two sources.

This qualitative standard would only apply with respect to activity on a **"trading venue"** which, consistent with the SEC's recently proposed amendments to Regulation ATS, would mean "a national securities exchange or national securities association that operates [a self-regulatory organization ("SRO")] trading facility, an [alternative trading system ("ATS")], an exchange market maker, an [over-the-counter] market maker, a futures or options market, or any other broker- or dealer-operated platform for executing trading interest internally by trading as principal or crossing orders as agent."[13] In this respect, the SEC intends for the Proposed Rules to apply broadly across exchanges, ATSs, Communication Protocol Systems[14] or any other form of trading venue where dealer activity occurs.

QUANTITATIVE STANDARD – APPLICABLE ONLY TO GOVERNMENT SECURITIES DEALERS

Proposed SEC Rule 3a44-2(a)(2) would establish a quantitative standard in which a person would be deemed to be buying and selling "government securities" as defined in Section 3(a)(42)(A) of the Exchange Act "as part of a regular business" if, in each of four out of the last six calendar months, it engaged in buying and selling more than $25 billion of trading volume in such securities, regardless of whether such person meets any of the qualitative standards. Based on the scope of Section 3(a)(42)(A) of the Exchange Act, this standard would cover trading in U.S. Treasury bills, notes floating rate notes, bonds, inflation-protected securities and Separate Trading of Registered Interest and Principal Securities (collectively, "U.S. Treasury Securities"), but it would exclude auction awards and repurchase or reverse purchase transactions in U.S. Treasury Securities.[15]

Determining whether this standard's trading volume threshold is met would require aggregating trading volumes "at the firm or legal-entity level," rather than at the market participant identifier ("MPID") or global firm level.[16] Additionally, the calculation of trading volumes would include transactions in any U.S. Treasury Securities that are currently reported to TRACE (*i.e.*, aggregate transaction volumes across covered products), but, again, would exclude auction awards and repurchase or reverse repurchase transactions in U.S. Treasury Securities.

EXCLUSIONS

The Proposed Rules would exclude (i) a person that has or controls total assets of less than $50 million or (ii) an investment company registered under the Investment Company Act of 1940.

Importantly, these exclusions would not provide an exclusion from the definition of a dealer or government securities dealer for all purposes and existing interpretations and precedent would continue to apply.[17]

AGGREGATION PROVISIONS

"Own Account"

The Proposed Rules would define a person's "own account" to mean, subject to certain exceptions, any account: (i) held in the name of that person; (ii) held in the name of a person over whom that person exercises "control" (as defined below) or with whom that person is under common control; or (iii) held for the benefit of those persons identified in (i) and (ii).

The following types of accounts would be excluded from being aggregated with another account for purposes of the definition of "own account":

- An account that is held in the name of a person who is a registered broker, dealer, government securities dealer, or registered investment company.
- With respect to a registered investment adviser, an account held in the name of a client of the adviser, unless the adviser controls the client as a result of the adviser's right to vote or direct the vote of voting securities of the client, the adviser's right to sell or direct the sale of voting securities of the client, or the adviser's capital contributions to or rights to amounts upon dissolution of the client.
- An account of a person under common control with another person solely because both persons are clients of a registered investment adviser, unless such accounts constitute a parallel account structure,

which means "a structure in which one or more private funds (each a 'parallel fund'), accounts, or other pools of assets (each a 'parallel managed account') managed by the same investment adviser pursue substantially the same investment objective and strategy and invest side by side in substantially the same positions as another parallel fund or parallel managed account."[18]

Although a person who has or controls less than $50 million in total is excluded from the Proposed Rules, its trading volume or activities may need to be considered and potentially aggregated with those of another person if within the definition of "own account" with respect to such other person.

According to the SEC, "[t]he Proposed Rules' aggregation provisions are designed to account for trading activity within a corporate family in which trading activity at a firm or legal-entity level is employed on behalf of or for the benefit of another legal entity. In the case of registered investment advisers that have no controlling ownership interest in an entity for which they are solely managing client assets, the trading activities of the adviser and each client are independent of each other and are not for the benefit of the adviser or any other client."[19] In this regard, the Proposed Rules would not require aggregation solely because a registered investment adviser exercises investment discretion over the assets of its clients.[20]

"Control"

The Proposed Rules would incorporate the definition of "control" under SEC Rule 13h-1, which means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of securities, by contract, or otherwise. For these purposes, any person that directly or indirectly has the right to vote or direct the vote of 25% or more of a class of voting securities of an entity or has the power to sell or direct the sale of 25% or more of a class of voting securities of such entity, or in the case of a partnership, has the right to receive, upon dissolution, or has contributed, 25% or more of the capital, is presumed to control that entity.

COMPLIANCE PERIOD

The Proposed Rules would be subject to a one-year compliance period from the effective date of any final rules, which is intended to provide time for market participants to, as applicable, register with the SEC and apply for membership in an SRO, typically the Financial Industry Regulatory Authority, Inc. ("FINRA"). The proposed compliance period would *not* cover market participants whose activities following the effective date of any final rules require registration under those rules.

Conclusion

The Proposed Rules would significantly expand the definition of "dealer" and "government securities dealer." While the SEC would primarily expect PTFs and certain private funds/hedge funds to be required to register, investment advisers and other market participants could potentially also become subject to registration as dealers/government securities dealers. Registration would subject these market participants to a comprehensive regulatory regime, including financial responsibility/capital, books and records, reporting and disclosure (including financial reporting), and personnel licensing and registration requirements, as well as the examination and enforcement authority of the SEC, FINRA and/or other SROs. Similarly, banks and foreign banks that come within the definition of a "government securities dealer" under the Proposed Rules would be

required to comply with the relevant federal banking regulators' regulatory regime governing such activities. Registration of these market participants also raises practical considerations, both with respect to the initial registration and the ongoing operation of these market participants.[21]

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Endnotes

[1] *See* Further Definition of "As a Part of a Regular Business" in the Definition of Dealer and Government Securities Dealer, Exchange Act Release No. 94524 (Mar. 28, 2022), 87 FR 23054 (Apr. 18, 2022) ("Proposing Release").

[2] Section 3(a)(9) of the Exchange Act defines a "person" as "a natural person, company, government, or political subdivision, agency, or instrumentality of a government."

[3] *See also* Proposing Release at 23062, n. 87, which states that "facts indicating a person may be acting as a 'dealer' include underwriting, as well as buying and selling directly to securities customers together with conducting any of an assortment of professional market activities such as providing investment recommendations, extending credit and lending securities in connection with transactions in securities, and carrying a securities account… Accordingly, a person may still be acting as a dealer even if they do *not*, under the Proposed Rules, engage in a routine pattern of buying and selling securities that has the effect of providing liquidity to other market participants."

[4] Proposing Release at 23066.

[5] *Id*.

[6] *Id*.

[7] *Id*.

[8] *Id*.

[9] *Id*.

[10] *Id.* at 23068.

[11] *See* Amendments regarding the Definition of "Exchange" and Alternative Trading Systems (ATSs) that Trade U.S. Treasury and Agency Securities, National Market System (NMS) Stocks, and Other Securities, Exchange Act Release No. 94062 (Jan. 26, 2022), 87 FR 15496 (Mar. 18, 2022).

[12] Proposing Release at 23068.

[13] *Id*. at 23069.

[14] Although the SEC does not specifically define the term "Communication Protocol System," it states that the term includes "electronic systems that offer the use of non-firm trading interest and make available communication protocols to bring together buyers and sellers of securities but do not fall within the current definition of an 'exchange' under federal securities laws." *Id*. at 23070.

[15] *Id*. at 23071, n. 165.

[16] *Id*., n. 164.

[17] *See also* note 3, *supra*, and accompanying text.

[18] *See* proposed SEC Rule 3a5-4(b)(4) and proposed SEC Rule 3a44-2(b)(4). The proposed definition of "parallel account structure" corresponds to definitions of "parallel fund structure" and "parallel managed account" under Form PF.

[19] Proposing Release at 23075.

[20] *Id*. at 23074, n. 185.

[21] For example, while FINRA generally has 180 calendar days to review a New Member Application, preparing to become a FINRA member and obtaining FINRA approval could take longer, which could be problematic in light of the proposed one-year compliance period. In addition, applying the broker-dealer regulatory regime to private funds/pooled investment vehicles – as opposed to just the funds' managers/investment advisers – may require changes in existing fund structures.