# Bond Case Briefs

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## SEC Proposes Significant Expansion of Firms That Must Register as Dealers: Sidley

On March 28, 2022, the U.S. Securities and Exchange Commission (SEC) unanimously proposed rules to further define activity that requires registration as a "dealer" or "government securities dealer" with the SEC (the Proposal).1 The Proposal would generally require any person, which would include a natural person or legal entity, that engages in a routine pattern of buying and selling securities (or government securities) that has the effect of providing liquidity to other market participants to have to register as a dealer pursuant to Section 15(b) of the Securities Exchange Act of 1934, as amended (the Exchange Act) (or as a government securities dealer pursuant to Section 15C of the Exchange Act).

Specifically, the SEC is proposing two rules — Proposed Rules 3a5-4 and 3a44-2 under the Exchange Act — to further define what it means to trade securities or government securities for one's own account "as part of a regular business" in a manner that would require a person to register as a "dealer" or a "government securities dealer," respectively, absent an exception or exemption (other than the so-called "trader" exception/exemption from such definitions).2

According to the SEC, the impetus for the Proposal is advancements in electronic trading and technology across securities markets that have given rise to unregistered market participants (referred to as "proprietary trading firms") playing an increasingly significant "liquidity providing role" in overall trading and market activity.3 Alleging that certain of these unregistered liquidity-providing firms are performing traditional "dealer" activity, the SEC is concerned that an uneven playing field has developed where some market participants are subject to regulation and others are not. This uneven application of regulatory oversight, according to the SEC, makes it difficult for regulators to detect, investigate, and understand significant market events, such as the "flash rally" in the Treasury markets in October 2014.

Hedge fund managers that actively trade will need to carefully consider whether they fall within the scope of the proposed rules and would therefore have to register as a dealer (or government securities dealer). If so, such hedge funds would face immensely greater regulatory scrutiny and compliance costs as they would become subject to SEC rules (e.g., net capital requirements, increased recordkeeping, risk management), self-regulatory organization rules (e.g., trade reporting, self-reporting of rule violations), and increased examinations and enforcement investigations.

The Proposal's comment deadline is the later of (i) Friday, May 27, 2022 (60 days after issuance of the Proposal), or (ii) 30 days after publication of the Proposal in the *Federal Register*.

**Background**

Section 3(a)(5)of the Exchange Act generally 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."4 This

statutory exclusion from the definition of "dealer" is often referred to as the "trader" exception.5

According to the SEC, while traders and dealers engage in the same core activity — buying and selling securities for their own account — their level of activity varies in absolute terms and in regularity. For example, the SEC has stated that dealers often buy and sell contemporaneously and quickly enter into offsetting transactions to minimize the risk associated with a position.6 In contrast, the SEC has said that traders are "market participants who provide capital investment and are willing to accept the risk of ownership in listed companies for an extended period of time" and that "it makes little sense to refer to someone as 'investing' in a company for a few seconds, minutes, or hours."7

The SEC last indicated that it might consider a rulemaking related to distinguishing a dealer from a trader in 2014 when the then-Chair of the SEC announced, as part of a number of other market structure initiatives, that she had asked the staff to recommend a rulemaking to "clarify the status of unregistered active proprietary traders to subject them to [SEC] rules as dealers."8 However, the SEC did not promulgate a proposal until now.

**Further Definition of "As Part of a Regular Business"**

The operative concept in the definitions of "dealer" and "government securities dealer" that distinguishes the regulated entity from the unregulated trader is that the dealer is engaged in buying and selling securities for its own account "as part of a regular business." Accordingly, the Proposal is designed to further define what "as part of a regular business" means by defining three qualitative standards intended to more precisely identify activities of certain market participants who assume dealerlike roles. Specifically, the proposed new rules seek to identify persons whose trading activity in the market "has the effect of providing liquidity" to other market participants.

Under the proposed rules, a person would be engaged in buying and selling securities (or government securities)9 for its own account "as a part of a regular business" if that person engages in a "routine pattern" of buying and selling securities (or government securities) that has the effect of providing liquidity to other market participants by

1. Routinely10 making roughly comparable11 purchases and sales of the same or substantially similar12 securities in a day;13
2. Routinely expressing trading interests14 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
3. 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.15

For persons buying and selling government securities, there would be an additional quantitative standard that, if met, would automatically deem the person to be engaging in the activity "as part of a regular business," irrespective of whether the person meets any of the other qualitative criteria. Under this standard, a person engaged in buying and selling more than $25 billion of trading volume in government securities in each of four of the last six calendar months would be deemed to be doing so "as part of a regular business."16

Notably, the proposed rules relate only to the interpretation of the Exchange Act's "dealer" and "government securities dealer" definitions under Sections 3(a)(5) and 3(a)(44) of the Exchange Act, respectively. The SEC is not proposing a comparable rule with respect to the Exchange Act's "municipal securities dealer" definition under Section 3(a)(30) of the Exchange Act or "security-

based swap dealer" under Section 3(a)(71) of the Exchange Act.

There would not be a presumption that a person is not a dealer (or government securities dealer) solely because that person does not satisfy (1), (2), or (3) above.17

**Exclusions From the Proposed Rules; Intersection of the Proposed Rules With Other Exceptions and Exemptions**

The proposed rules would exclude two specific categories of persons from their coverage — meaning that if a person meets the criteria noted above but falls within an exclusion, such person's activities would not — by virtue of these criteria alone — be deemed to be "part of a regular business." The exclusions are for a person that

1. Has or controls total assets of less than $50 million or
2. Is an investment company registered under the Investment Company Act of 1940.18

Because there is no presumption under the proposed rules that a person is not a dealer (or government securities dealer) if not meeting the relevant criteria described above, market participants would still need to analyze their activity under prior SEC guidance and precedent, and applicable case law, to determine whether the activities may otherwise implicate the dealer and/or government securities dealer definitions.19

The proposed rules also would not change other available statutory or regulatory exceptions or exemptions that may be available to a particular person. For example, banks would continue to enjoy the various bank-specific exceptions and exemptions from the "dealer" and "government securities dealer" definitions.20 Moreover, even if a person is deemed to implicate the "dealer" and/or "government securities dealer" definitions, an exemption from the requirement to register may remain available — such as the exemption for foreign broker-dealers complying with Rule 15a-6 under the Exchange Act.21

**Aggregation of Accounts Under the Proposal**

To account for variations in corporate structure and ownership among different persons, and to prevent possible circumvention of the proposed rules, the Proposal would also define the terms "own account" and "control." The proposed definitions are designed to determine which accounts must be considered for purposes of evaluating whether a person meets the criteria described above. Specifically, a person's "own account" would be defined to mean any account

1. held in the name of that person,
2. held in the name of a person over whom that person exercises control or with whom that person is under common control (subject to certain exceptions, as discussed below), or
3. held for the benefit of those persons identified in (i) and (ii).

*Exception for Certain Accounts*

The Proposal sets forth certain exceptions under prong (ii). Specifically, an account held in the name of a person over which the person exercises control or with whom the person is under common control would not be considered for purposes of determining whether the person may be a dealer/government securities dealer if the account meets one of the following exceptions:

(A) Broker-Dealer and Investment Company Accounts — The account is in the name of a registered broker, dealer, or government securities dealer or an investment company registered under the Investment Company Act of 1940.

(B) Investment Advisory Accounts for Clients That Are Not Controlled by the Adviser — With respect to an investment adviser registered under the Investment Advisers Act of 1940 (Advisers Act), the account is 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).22

(C) Accounts for Shared Clients of an Adviser (Other than Parallel Account Structures) — With respect to any person, the account is held in the name of another person that is deemed under common control with that person solely because both persons are clients of an investment adviser registered under the Advisers Act (an RIA), unless the accounts constitute a "parallel account structure."

Under the Proposal, the term "control" would have the same meaning as prescribed in Rule 13h-1 (Large Trader Reporting) under the Exchange Act, which generally presumes control at a level of 25% interest.23

The term "parallel account structure" would be defined to mean "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."24

**Investment Advisers Under the Proposal**

RIAs would be subject to the proposed rules.25 The SEC states that an RIA could become subject to the proposed rules with respect to trading for its own proprietary account, as well as the accounts of clients the RIA controls, unless an exclusion or exemption applies. Importantly, the fact that the RIA has discretionary authority over a client's account would not itself cause the account's trading activity to be aggregated with the activity for the RIA's own proprietary account. Rather, aggregation would be required only if the RIA controls the client itself.26

If the Proposal is adopted in its current form, RIAs will need to carefully consider which advisory clients are considered under their control and hence which clients' advisory accounts must be aggregated with the RIA's own proprietary account for purposes analyzing the RIA's activities under the proposed rules.

**Dealer Registration With the SEC and Self-Regulatory Organizations**

If adopted, any person deemed to be acting as a dealer (or government securities dealer) under the proposed rules would, absent an available exception or exemption or "no-action" position, have to register with the SEC and become a member of a national securities exchange and/or FINRA and comply with applicable SEC and exchange/FINRA rules within one year of the effective date of any final rules.27 Compliance with certain of these rules could prove challenging for some firms based on their current business model. For example, the SEC generally requires all registered broker-dealers to comply with its net capital rule under Rule 15c3-1 of the Exchange Act. The SEC's net capital rule, as well as certain FINRA rules, imposes substantial limitations/restrictions on the ability to withdraw capital from such broker-dealer, and FINRA or an exchange could impose limits/restrictions on the amount of leverage used by a broker-dealer. This could restrict liquidity for investors in a private investment/hedge fund that seeks to trade principally through a wholly owned subsidiary that is a registered broker-dealer.

While it is currently possible for certain exchange-member dealers to avoid FINRA membership, market participants would be wise to not expect the current exemption from FINRA membership to last. Section 15(b)(8) of the Exchange Act generally requires that a broker-dealer become a member of a national securities association (i.e., FINRA, as the sole-registered securities association), unless the broker-dealer effects transactions solely on an exchange of which it is a member.28 Rule 15b9-1 provides a further exemption from FINRA membership, generally allowing an exchange-member dealer that carries no customer accounts and effects all of its trades with or through other registered broker-dealers to avoid FINRA membership.29

In 2015, however, the SEC proposed amendments to significantly narrow the Rule 15b9-1 exemption from FINRA membership.30 It seems reasonable to expect that the SEC might repropose the narrowing of this exemption in the coming months to ensure that dealers captured by the Proposal are subject to regulatory oversight by FINRA, as the primary regulator of the over-the-counter (OTC) markets. Exchanges are not well positioned to regulate and oversee the trading activity of, for example, a government securities dealer that transacts almost exclusively in the OTC treasury markets. Accordingly, we anticipate that proposed changes to Rule 15b9-1 may be forthcoming.

**State "Blue Sky" Law Provisions Would Continue to Apply**

The Proposal relates only to the interpretation of the Exchange Act's "dealer" and "government securities dealer" definitions. Individual state "Blue Sky" law provisions would continue to apply, although many states' Blue Sky laws contain provisions that require such laws to be interpreted to promote uniformity with other states' laws and the "related federal regulation." As such, generally, a person that is not deemed to be a dealer (or government securities dealer) under the Exchange Act should, as a general matter, not be subject to separate registration under state Blue Sky laws. However, to the extent that a person is required to be registered as a dealer (or government securities dealer) under the Exchange Act, the state Blue Sky laws do not separately regulate securities "dealers" versus "government securities dealers" but rather regulate "broker-dealers." In this regard, a broker-dealer could include both a securities dealer and a government securities dealer.

As a general matter, a person registered as a dealer or government securities dealer under the Exchange Act and which (i) does not maintain a place of business in a particular state and (ii) effects securities transaction in a state solely with certain enumerated categories of institutional investors (including one or more state-registered broker-dealers) would not be required to be separately registered as a broker-dealer under the applicable state's Blue Sky law. Even if a person is required to become registered under a state's Blue Sky laws, Section 15(i)(1) of the Exchange Act preempts the states from imposing requirements on an Exchange Act–registered dealer with respect to, among other things, capital, margin, keeping records, and financial and operational reporting requirements that "differ from, or are in addition to, the requirements in those areas established under [the Exchange Act]."31

**Sidley Austin LLP** – Andrew P. Blake, James Brigagliano, Kevin J. Campion, David M. Katz, John I. Sakhleh, Barbara J. Endres and Charles A. Sommers

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1 Exchange Act Release No. 94524 (March 28, 2022), https://www.sec.gov/rules/proposed/2022/34-94524.pdf.
2 The Proposal does not address the definitions of "municipal securities dealer" in Section 3(a)(30)

of the Exchange Act or "security-based swap dealer" in Section 3(a)(71) of the Exchange Act.
3 The SEC estimates that the Proposal would require approximately 51 persons to register as dealers and 46 persons to register as government securities dealers. Proposal at 171-172.
4 15 U.S.C. 78c(a)(5)(A) and (B). Similarly, Section 3(a)(44) of the Exchange Act provides, in relevant part, that the term "government securities dealer" means "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." 15 U.S.C. 78c(a)(44).
5 Exchange Act Release No. 46745 (Oct. 30, 2002), 67 FR 67496, 67498–67500 (Nov. 5, 2002) (explaining that "a person that is buying securities for its own account may still not be a 'dealer' because it is not 'engaged in the business' of buying and selling securities for its own account as part of a regular business" and that "[t]his exclusion is often referred to as the dealer/trader distinction").
6 The SEC has identified a number of other indicators of dealer activity, including, among other things, (1) acting as a market maker or specialist on an organized exchange or trading system, (2) acting as a de facto market maker or liquidity provider, and (3) holding oneself out as buying or selling securities at a regular place of business.
7 Proposal at 21.
8 Former SEC Chair, Enhancing Our Equity Market Structure (June 5, 2014), https://www.sec.gov/news/speech/2014-spch060514mjw.
9 The SEC notes that the proposed rules would apply to any security or government security (as defined in Sections 3(a)(10) and 3(a)(42) of the Exchange Act, respectively), "including any digital asset that is a security or a government security within the meaning of the Exchange Act." See Proposal at n.36.
10 The Proposal states that "routinely" means "more frequent than occasional but not necessarily continuous" and that this interpretation of the term "will 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." Proposal at 48-49.
11 The Proposal states that "roughly comparable" means "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." Id. at 50. The SEC offers no bright-line test for "roughly comparable" but additionally states that "a person that closes or offsets, in the same day, the overwhelming majority of the positions it has opened, has likely made 'roughly comparable purchases and sales.' " Id.
12 With respect to the meaning of "the same or substantially similar," the Proposal states that securities are the "same" if they are "securities of the same class and having the same terms, conditions, and rights," such as securities with the same CUSIP. Id. at 52. Whether securities are considered to be "substantially similar" would be a facts and circumstances analysis, taking into account such factors as whether "(1) 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 (2) 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." Id. at 53.
13 This category would encompass "day trading" activity meeting this criteria — activity that has historically been regulated by self-regulatory organization margin rules, such as, Rule 4210(f)(8)(B) of the Financial Industry Regulatory Authority, Inc. (FINRA).
14 The Proposal states that the term "trading interest" is intended to capture "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 SEC intends the proposed rules to address. Id. at 57.

15 See proposed Rules 3a5-4(a)(1) and 3a44-2(a)(1).
16 See proposed 3a44-2(a)(2).
17 See proposed Rules 3a5-4(c) and 3a44-2(c). See also Proposal at 35-37 and 94-95.
18 See proposed Rules 3a5-4(a)(2) and 3a44-2(a)(3).
19 For example, an entity that is acting as an underwriter would still be required to register as a dealer. Proposal at 94.
20 See, e.g., Exchange Act Sections 3(a)(5)(C) and 3(a)(44)(C).
21 17 CFR 240.15a-6. See Proposal at 29. Rule 15a-6 under the Exchange Act provides a "foreign broker or dealer" (as defined in the rule) a limited exemption from the registration requirements of Sections 15(a)(1) and 15B(a)(1) of the Exchange Act (that is, with respect to securities dealers and municipal securities dealers, but not government securities dealers). Treasury Regulation 401.7, however, provides a substantially similar exemption with respect to the registration requirements in Section 15C(a) of the Exchange Act. 17 CFR 401.7.
22 Put another way, the fact that a registered investment adviser (RIA) has discretionary authority over a client's account would not itself cause the account's trading activity to be attributed to the investment adviser for purposes of the proposed rules. On the other hand, if the investment adviser is deemed to control the client, then the trading activity for that client account would be attributed to the investment adviser.
23 17 CFR 240.13h-1. Rule 13h-1(a)(3) provides that "the term control (including the terms controlling, controlled by and under common control with) 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 purposes of this section only, 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."
24 See proposed Rules 3a5-4(b)(4) and 3a44-2(b)(4).
25 Although there is an exclusion from the definition of "investment adviser" for any broker or dealer whose performance of advisory services is solely incidental to the conduct of such person's business as a broker or dealer, and who receives no special compensation therefor (see Section 202(a)(11)(C) of the Advisers Act), there is no comparable exception from the definition of "dealer" (or "broker") under the Exchange Act for an RIA.
26 See also note 22, supra.
27 The compliance period would apply only to persons captured by the proposed rules as of the effective date of any final rules but would not cover market participants whose activities are captured by the final rules only after the effective date. Proposal at 34-35. This compliance period could prove challenging as, for example, it can take six months or longer to become a FINRA member.
28 15 U.S.C. 78o(b)(8).
29 17 CFR 242.15b9-1. Rule 15b9-1 generally exempts a broker-dealer from the requirement to become a member of a national securities association if it is a member of a national securities exchange, carries no customer accounts, and has annual gross income of no more than $1,000 that is derived from securities transactions effected otherwise than on a national securities exchange of which it is a member. Under the rule, income derived from transactions for the dealer's own account with or through another registered broker-dealer does not count toward this $1,000 de minimis threshold.
30 Exchange Act Release No. 74581, 63 FR 18036 (Apr. 2, 2015).
31 15 U.S.C. 78o(i)(1)

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