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[SEC Expands Dealer Definition to Capture Large Traders Regularly Providing Liquidity to the Markets: Goodwin]

High-frequency traders, private funds, decentralized exchange automated market makers, and even state pension plans should consider whether the expanded dealer definition triggers the need to register as a securities dealer with the SEC and with an SRO like FINRA.

On February 6, 2024, the SEC [adopted rules] to greatly expand the Exchange Act definitions of "dealer" and "government securities dealer" by further defining the phrase "as a part of a regular business." In doing so, the SEC has significantly narrowed the existing dealer/trader distinction long recognized by the SEC through staff guidance and interpretations. The rulemaking is likely to require dealer registration by proprietary trading firms (PTF) and certain large private funds that regularly provide liquidity in the securities markets. Even state pension plans and their managers could be swept into the SEC's dealer regime if they trip into the new qualitive standards discussed below.

Policy Underlying the Expanded Dealer Definition

The Exchange Act definition of "dealer" historically excluded from its scope a trader who "buys or sells securities…for such person's own account…but not as a part of a regular business." The SEC, under Chair Gensler grew concerned with certain market participants whose activity and market share in providing liquidity to the equities and government securities markets was significant and existed outside of the dealer regime and in a mostly unregulated way. The SEC has expressed particular concern that investors and the markets have lacked important protections that, in the view of a majority of the commissioners, would otherwise result from such an entity's registration and regulation under the Exchange Act. The adopting release also pointed to the absence of obligations and regulatory oversight that would otherwise promote market resiliency and stability. All of this culminated in the adoption of two new rules requiring dealer registration and FINRA or other SRO membership for these large and active market participants.

New Exchange Act Rules 3a5-4 and 3a44-2

New Exchange Act Rules 3a5-4 and 3a44-2 further define the phrase "as a part of a regular business" in Exchange Act Sections 3(a)(5) and 3(a)(44) using certain qualitative standards that, if tripped, would require dealer or government securities dealer registration under Exchange Act Sections 15 and 15C, respectively, along with SRO membership (likely with FINRA, although exchange membership could be a viable path). The rules also define trading in one's "own account" to mean an account held in the name of that person or held for the benefit of that person.

Top 10 Takeaways (And Dozens More Requiring Consideration)

1. The SEC's focus is on market participants that "engage in a regular pattern of buying and selling securities (or government securities) that has the effect of providing liquidity to other market participants." However, the scope of the proposal is vast—all securities, including equities, fixed income, treasuries, **municipal securities**, and, wait for it…crypto assets that are securities.

2. Any person, firm, or even a private fund that has or controls total assets of at least $50 million and satisfies one of two new qualitative standards must register as a dealer. The new qualitative standards that the SEC considers to be "dealer-like" and, in Chair Gensler's view, are "de facto market making," are:

> a. *Regularly expressing* trading interest that is at or near the best available prices on both sides of the market for the same security that is communicated and represented in a way that makes it accessible to other market participants; or
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> b. 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.

3. Investment companies registered under the 40 Act are exempt, as are central banks, sovereign entities, and international financial institutions (with new definitions to match).

4. Private funds with at least $50 million of AUM that trip either of the qualitative standards would need to register as dealers. This topic drew significant attention from Commissioner Peirce during the SEC open meeting and raises significant questions for large PE, VC, hedge, and state pension funds. For example, commenters sought from the SEC, but were refused, clarification that the new rules would not apply to governmental plans, including public pensions, nor to state administrators managing state funds or to city administrators managing the city pension funds through an exclusion from the proposed rules. One particular commenter expressed concerns that the proposed standards could subject state boards and similar investment fiduciaries and/or administrators of state pension funds to the rules. The SEC chose not to exempt these arrangements because, in the SEC's view, the final rules "should not" capture these arrangements. Unfortunately, the stakes are too high to casually rely on such a flimsy assurance. As a result, each of these funds and plans will likely need to conduct an analysis of their market activity and revenue streams to determine whether they need to register as dealers.

5. The introduction of "qualitative" standards essentially gives the SEC limitless ability to subjectively determine who's in and who's out. And many likely fear that the SEC will use the much lamented "regulation by enforcement" approach in this area (a topic that came up during the open meeting). For example, what does "regularly" mean? What does "primarily" mean? Another easy example worth highlighting is the crypto market and the compounding uncertainty of whether these new rules sweep in DEX AMMs or DEXs themselves and other liquidity providers. Commissioner Peirce asked the Director of the Division of Trading and Markets several questions about scope and applicability, including about potential distinctions between software coders, the software itself, and those who eventually utilize the software to provide liquidity or otherwise contribute to a pool of assets. In typical fashion, however, the rulemaking devotes little to this important discussion.

6. The SEC's use of "regularly" is designed to capture market participants "expressing trading interest that is at or near the best available prices on both sides of the market for the same security and is communicated and represented in a way that makes it accessible to other market participants." A market participant will be "regularly" expressing the requisite trading interest if doing so both within a trading day and over time. Regularly is not defined, though the SEC states that it is not intended to capture "isolated or sporadic" expressions of trading interest. The SEC does make clear that "a market participant does not need to be continuously expressing trading interest to be engaging in a 'regular' business." "Regularity" will also depend on the depth and liquidity of the underlying security. The SEC states that for a market as deep and liquid as U.S. treasuries, "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 to be caught by the expressing trading interest factor." The activity would have to occur in "more frequent periods." How frequent? Well, that is unclear, but the fact that the SEC used "one-off" as an example for the U.S. treasuries markets – the largest and deepest markets in the world, is slightly concerning. The SEC does note that that this factor also "would include 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."

7. Regarding the second qualitative standard and earning revenue "primarily from," the proposing release stated that deriving a majority of revenue from the activity would likely trigger the "primarily" factor. In the adopting release, the SEC notes that earning more revenue "from an appreciation in the value of [] inventory of securities than from capturing bid-ask spreads or incentive payment for liquidity provision" would be unlikely to be "considered to earn revenue 'primarily' from capturing bid-ask spreads or trading incentives." Ultimately, the SEC notes that the analysis turns on the "totality of the particular facts and circumstances," including in crypto asset security markets, despite the novel structures, products, and activities inherent therein.

8. The final rules dropped several aspects from the original proposal from early 2022, including:

> **a.** A proposed qualitative standard of making roughly comparable purchases and sales of the same or substantially similar securities in a day.
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> **b.** A proposed "aggregation" provision that would have otherwise considered "own account" to include accounts "held in the name of a person over whom that person exercises control or with whom that person is under common control." Instead, the final rules include an anti-evasion provision that prohibits persons from evading the registration requirements by: (1) engaging in activities indirectly that would satisfy the qualitative factors; or (2) disaggregating accounts.
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> **c.** A bright line quantitative standard under which persons engaged in certain levels of activity in the U.S. Treasury market would be defined to be buying and selling securities "as part of a regular business," regardless of whether they met any of the qualitative factors.

9. A knock-on concern for any private funds captured by the expanded dealer definition is the likely loss of the ability for their personnel to rely on the so-called "issuer's exemption" in Exchange Act Rule 3a4-1 when engaging in sales activity. Rule 3a4-1 is not available to an associated person of an issuer if such person is an "associated person of a broker or dealer." The scope for this limitation covers situations of common control with a broker or dealer. That said, because the expanded dealer definition would only apply to a fund with at least $50 million AUM, it is less likely that the personnel of funds of that size would be relying on Rule 3a4-1 (instead, they would likely be using third party placement agents or their salespeople would be registered with an affiliated broker).

10. Another interesting point to consider is that certain public exchanges give execution priority to "customer" orders (provided the customer is not classified as a professional customer). One of the key definitions of customer is that the person is not a broker or dealer. Market participants caught up by the expanded dealer definition should consider the potential loss in priority and how that would affect their strategies and routing decisions.

Compliance Date + Implementation Challenges

The rulemaking effective date will be 60 days after the adopting release is published in the Federal Register (potentially out as far as June depending on the FR publication date). Compliance will be required within one year after that period has expired, but that is only for those already engaging in covered activity prior to the compliance date. Those who begin engaging in this activity one day later could not do so until registering as a dealer and becoming a FINRA or other SRO member, which, as noted below, that could take the better part of a year.

Implementation challenges are likely, although SEC staff indicated that FINRA has committed to expedite its new membership process. Unfortunately, even on an expedited basis, it could take applicants a month or longer to complete the application and several months to receive FINRA's approval. This is particularly true if FINRA receives a deluge of several dozen or more applications all around the same time (including applications to register as a broker-dealer and ATS if the Commission adopts the expanded meaning of what it means to be an exchange under Exchange Act Rule 3b-16). Registrants will need to address such matters as examinations for supervisors and other registered persons, supervisory policies and procedures, business continuity plans and, perhaps most importantly, minimum net capital and aggregate indebtedness standards. Individual traders caught by the definition will find themselves in the position of having to register as dealers in their individual capacity or forming an entity to be the registered dealer. The SEC removed the aggregation provision from the final rule, but included an anti-evasion provision that prohibits persons from evading the registration requirements by: (1) engaging in activities indirectly that would satisfy the qualitative factors; or (2) disaggregating accounts. The release is unclear, however, about potential cases where a fund group has multiple funds that trigger the registration requirement and whether each fund has to register, or about whether the adviser, fund itself, or both must register.

Closing Thoughts

The expanded dealer definition continues the SEC's trend of broad rulemaking that expands the agency's oversight in existing areas and into new areas, often with unforeseen and unintended consequences. Coupled with the SEC's pending proposal to amend the meaning of what it means to be an exchange, this rulemaking is central to the SEC's plans to regulate additional market participants (like "communication protocol systems" and this broader universe of securities dealers), both in traditional financial markets and beyond (including crypto and DeFi).

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