SEC Expands "Dealer" Definitions to Cover Significant Liquidity Providers

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On February 6, 2024, the U.S. Securities and Exchange Commission (the "Commission") adopted new rules 3a5-4 and 3a44-2 (collectively, the "Final Rules"), under the Securities Exchange Act of 1934 (the "Exchange Act") further defining the phrase "as a part of a regular business" as used in the statutory definitions of "dealer"[1] and "government securities dealer"[2] set forth in Sections 3(a)(5) and 3(a)(44) of the Exchange Act, respectively.[3] Though substantially narrower than the rules proposed in 2022 (the "Proposed Rules"),[4] the Final Rules are potentially very significant for certain hedge funds and other investors that engage in high-frequency trading (private equity funds and venture capital funds, as a result, should not be affected by the Final Rules). In addition, they may be significant beyond the institutions that the SEC has specifically targeted for registration, as they abandon the long-standing understanding of the statutory interpretations[5] in favor of a formal position that certain forms of trading that have the *de facto* effect of providing liquidity to the market constitute "dealer" activity without regard to whether the trader intended to provide liquidity as a service, the nature of the relationship of the trading entity to its counterparties, or the manner in

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1 The term "dealer" means any person engaged in the business of buying and selling securities (not including security-based swaps, other than security-based swaps with or for persons that are not eligible contract participants) for such person's own account through a broker or otherwise. 15 U.S.C. § 78c(a)(5)(A). Currently, the term "dealer" does not include a person that buys or sells securities (not including security-based swaps, other than security-based swaps with or for persons that are not eligible contract participants) for such person's own account, either individually or in a fiduciary capacity, but not as a part of a regular business. 15 U.S.C. § 78c(a)(5)(B).

2 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 a part of a regular business. 15 U.S.C. § 78c(a)(44)(A).

3 Further Definition of "As a Part of a Regular Business" in the Definition of Dealer and Government Securities Dealer, Release No. 34-99477 (Feb. 6, 2024). The Final Rules, with full texts of the amendments and related guidance are available here. For ease of exposition, we use the term "dealer" to describe government securities dealers.

4 Further Definition of "As a Part of a Regular Business" in the Definition of Dealer and Government Securities Dealer, 87 Fed. Reg. 23054 (proposed Mar. 28, 2022).

5 This historical understanding is generally described by the Commission as the "dealer-trader" distinction, which is operationalized by examining a set of "indicia" or "hallmarks" of dealing that have been developed by the Commission in a series of rulemaking releases, orders and no-action letters.

which it makes money. As such, the new rules create uncertainty as to the interpretation of the "dealer" definitions going forward.

The Final Rules identify certain activities deemed *de facto* market making, which would subject persons engaging in such activities to registration requirements for dealers and government securities dealers set forth in Sections 15 and 15C of the Exchange Act, respectively. Specifically, such activities include (1) "regularly" expressing trading interest at or near the best available prices on both sides of the market with respect to the same security (the "Expressing Trading Interest Factor") and (2) earning revenue primarily from capturing bid-ask spreads, buying at the bid and selling at the offer, or by capturing incentives offered by trading venues for providing liquidity (the "Primary Revenue Factor"). These are two of the four tests from the Proposed Rule, which also included another "qualitative" test intended to distinguish between persons engaging in isolated and sporadic securities transactions from those frequently trading in and out of names in roughly equal amounts on the same days and a "quantitative" test that would have deemed persons trading U.S. Treasuries at certain levels as dealers regardless of the manner of trading.

While the Final Rules will become effective on the date that is 60 days after the Final Rules are published in the *Federal Register*, the initial compliance date is one year from such date. This means that all market participants that currently engage in high-frequency or spread trading that triggers registration under the new rules will have until the compliance date to obtain approval for a new membership application submitted to the Financial Industry Regulatory Authority ("FINRA"). However, market participants that engage in such trading after the initial compliance date will immediately be deemed dealers subject to registration, meaning that such trading without registration will effectively be deemed unlawful after that date.

Elements of the Final Rules and Guidance for Compliance

- ***Qualitative Factors.*** As noted above, the Final Rules establish two non-exclusive factors to be used in determining whether a person (defined under the Final Rules in accordance with section 3(a)(9) of the Exchange Act to mean "a natural person, company, government, or political subdivision, agency, or instrumentality of a government") is engaged in buying and selling as part of a regular business. While these factors were adopted largely in the form proposed, the Commission made a few modifications and the adopting release accompanying the Final Rules (the "Adopting Release") includes important interpretive gloss:

- Expressing Trading Interest Factor. Per the Commission, this factor "will appropriately capture those market participants who are engaging in liquidity-providing activities similar to those traditionally performed by dealers or government securities dealers."[6]

  - *"Regularly" Expressing Trading Interest*. The Commission replaced the proposed term ("routinely") with "regularly" in response to industry concerns that "routinely" lacked clarity. In doing so, the Commission noted that the term "regular" is part of the statutory definition and should be better understood by the market.[7]

    While the usefulness of this wording change is questionable at best in light of the new context, the Commission advises in the Adopting Release that "whether a person's activity is 'regular' will depend on the liquidity and depth of the relevant market for the security" and illustrates that in highly liquid markets, "regular" might constitute more frequent expression of trading interests both intraday and across days on both sides of the market, while in less liquid markets, "regular" might account for wider spreads and more frequent interruptions in communicating trading interest.[8] Additionally, persons covered by the rule would be very active, as demonstrated by their playing a "key role . . . in price discovery and the provision of market liquidity."[9]

  - *"Trading Interest" Definition*. The Commission adopted the Expressing Trading Interest Factor with only minor, non-substantive changes from the definition of "trading interest" in the Proposed Rule. In the Adopting Release, the Commission defines "trading interest" as either (1) an order (defined under 17 C.F.R. § 240.3b-16(c) as "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"), or (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."[10] Notably, a pricing element is not necessarily required notwithstanding that the test elsewhere requires being at or near the best available prices. The Commission justifies this breadth as

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6 Final Rules, *supra* note 3, at 33.

7 *See* 15 U.S.C. § 78c(a)(5).

8 *See* Final Rules, *supra* note 3, at 36–37.

9 *Id.* at 34 (quoting 87 Fed. Reg. at 23068).

10 *Id.* at 41.

necessitated by technology and the varied modern mechanisms for pooling liquidity in different securities markets, including crypto securities.

- *Meaning of "Both Sides of the Market."* In response to several industry comments seeking clarity on the application of the phrase "both sides of the market," the Commission clarifies that the new rule only applies to expression of interest on both sides of a market for the same security rather than related securities. As for the time period, the Commission clarifies that there is no requirement for simultaneity in the expressed trading interest.

- *Meaning of "Accessible to Other Market Participants."* Some comments to the Proposed Rule noted that the phrase "accessible to other market participants" in the expressing trading interest factor was vague. In the Adopting Release, the Commission clarifies that the phrase should be understood in accordance with its plain meaning "that a person expresses trading interests to more than one [other] market participant" even if that occurs through individual communications.[11]

- Primary Revenue Factor. Additionally, under the Final Rules, a person will be deemed to be engaged in buying and selling as part of a regular business if they "earn[] 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."[12] This factor is largely captured by the current understanding of the "dealer" business model. Per the Commission, this qualitative factor received the fewest comments of the three originally proposed.

- ***Aggregation and Anti-Evasion Provisions.*** The Final Rules take a narrower approach to aggregation by defining "own account" to include only accounts held in a person's name or for the benefit of that person, eliminating the inclusion of entities under common control as provided for in the Proposed Rules. In doing so, the Commission noted that it intends to analyze activities on an entity-by-entity basis rather than aggregating accounts across entities that are either controlled by or share common control with an entity.[13]

  However, to deter the establishment of multiple legal entities or accounts as a means of evading appropriate regulation under the Final Rules, the Commission includes an anti-evasion provision that captures "indirectly" satisfying one of the qualitative

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11 *Id.* at 49.

12 *Id.* at 243, 245.

13 *See id.* at 89.

tests as well as separating or breaking up accounts for the purpose of evading the dealer registration requirements.[14]

- ***Exclusions.*** Excluded from the ambit of the Final Rules are investment companies registered under the Investment Company Act of 1940 (but not hedge funds), persons who have or control total assets of less than $50 million, central banks,[15] sovereign entities[16] and international financial institutions.[17]

Implications for Market Participants

Though narrower than the Proposed Rules, the Final Rules are still very significant for those that engage in trading strategies that may fall on the wrong side of the new—and vague—"regularity" test. As noted by numerous commentators, registration as a broker-dealer and operating under such a registration is a significant and costly undertaking. Moreover, capital requirements for registered broker-dealers only recognize capital contributions as "good" capital if they are not (i) subject to an agreement providing an option to withdraw or (ii) intended to be withdrawn within one year of contribution.[18] Practically, this means that funds that the Final Rules would capture (primarily, hedge funds that engage in high-frequency trading or algorithmic trading) would likely not be able to register without, at a minimum, altering their terms for investor redemptions. It therefore seems likely that the new rules will have a material deterrent effect on relevant forms of high-frequency trading.

More broadly, while the Commission characterizes its new tests as "qualitative," the Expressing Trading Interest Factor is essentially quantitative in concept, as it triggers

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[14] *See id.* at 90–91.

[15] "Central bank" is defined under the Final Rules as "a reserve bank or monetary authority of a central government (including the Board of Governors of the Federal Reserve System or any of the Federal Reserve Bank and the Bank for International Settlements." *Id.* at 244, 246.

[16] "Sovereign entities" is defined under the Final Rules as "a central government (including the U.S. Government), or an agency, department, or ministry of a central government." *Id.* at 245, 247.

[17] "International financial institutions" is defined under the Final Rules as "the African Development Bank; African Development Fund; Asian Development Bank; Banco Centroamericano de Integración Económica; Bank for Economic Cooperation and Development in the Middle East and North Africa; Caribbean Development Bank; Corporación Andina de Fomento; Council of Europe Development Bank; European Bank for Reconstruction and Development; European Investment Bank; European Investment Fund; European Stability Mechanism; Inter-American Development Bank; Inter-American Investment Corporation; International Bank for Reconstruction and Development; International Development Association; International Finance Corporation; International Monetary Fund; Islamic Development Bank; Multilateral Investment Guarantee Agency; Nordic Investment Bank; North American Development Bank; and any other entity that provides financing for national or regional development in which the U.S. Government is a shareholder or contributing member." *Id.* at 244, 246.

[18] *See* Rule 15c3-1(c)(2)(i)(G).

registration based on whether a trader is providing liquidity frequently enough, and/or in enough volume to satisfy the "regularity" requirement. But while "regularity" is required to fall within the parameters of the new rules, those rules are interpretive in nature and appear to stand for the proposition that simply providing liquidity as a *de facto* result of trading can be trading "as a business" under the Exchange Act. As a statutory matter, it is not clear whether there is a principled basis for differentiating trading that is, or is not engaged in, "as a business" based on differences in quantity rather than kind. The rules may therefore invite further disputes over whether various types of trading may involve dealing.

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