ALERTS

SEC Targets Certain Proprietary Trading Firms and Private Funds With Expanded "Dealer" Definition

February 21, 2024

Executive Summary

On Feb. 6, 2024, the US Securities and Exchange Commission ("SEC" or "Commission") adopted new Rules 3a5-4 and 3a44-2 (together, "Final Rules")[1] under the Exchange Act to further define what it means to be "engaged in the business" of buying and selling securities for one's own account and, as such, required to register with the SEC as a "dealer" or "government securities dealer," as applicable (collectively, a "Dealer"). The Final Rules establish two non-rebuttable qualitative standards — one that targets the regularity of a market participant's expressions of trading interest ("Expressing Trading Interest" factor, as further defined below) and another that targets a market participant's primary source of revenue ("Primary Revenue" factor, as further defined below) — to determine if a market participant is required to register as Dealer. While the Final Rules have been significantly scaled back from the SEC's initial proposal ("Proposal"),[2] based on the qualitative standards set forth in the Final Rules, certain private investment funds and their advisers may be required to register as Dealers.

The Commission declined to adopt the two most controversial provisions of the Proposal. The first was an additional qualitative standard that would have required any persons who "routinely [makes] roughly comparable purchases and sales of the same or substantially similar securities (or government securities) in one day" to register as a Dealer.[3] The second was a quantitative standard that would have required any person who, in

four of the last six calendar months, bought or sold over $25 billion in US Treasuries to register as a "government securities dealer." However, in what appears to be a significant expansion from the Proposal, the Adopting Release notes market participants do *not* need to express trading interest continuously nor simultaneously be on both sides of the market to be captured by the Expressing Trading Interest test.

Additionally, the SEC declined to adopt the broad definition of "own account" included in the Proposal, which would have required that investment advisers aggregate activity across private funds and accounts managed by the adviser. Instead, the SEC adopted a definition of "own account" that focuses on the entity engaged in the dealer activity along with an anti-evasion prohibition designed to restrict circumvention of the Final Rules.

Final Rules

As adopted, the Final Rules require that, subject to limited exceptions, any person who "engages in a regular pattern of buying and selling securities [or government securities] for their own account that has the effect of providing liquidity"[4] by engaging in the below activities must register as a Dealer:

- Regularly express 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 ("Expressing Trading Interest" test);[5] or
- 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 ("Primary Revenue" test).[6]

While the SEC did not adopt the proposed "roughly comparable purchases and sales" qualitative standard, the SEC cautioned that such activity may still be "*de facto* market making under the [adopted] two qualitative tests or dealer activity under otherwise applicable precedent."[7] Further comments in the Adopting Release and a lack of clarity on key terms may permit broad interpretations of the two adopted qualitative tests to cover some of the activities previously captured by the "roughly comparable purchases and sales" test. The Commission also emphasized that the two adopted standards are non-exclusive, meaning

that market participants must continue to assess their activities against existing SEC guidance and court precedent. This may be disappointing for market participants looking for additional clarity in light of recent court cases.[8]

Expressing Trading Interest Test

Under the Expressing Trading Interest test, a person "*regularly* expressing 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" is engaged in buying and selling securities for its own account "as a part of a regular business."[9] While the Commission stated it adopted this test largely as proposed, it made two significant textual changes. The first was to add the phrase "for the same security" to explicitly provide in the Final Rules that the expressions of trading interest must be for the same security. The second change replaced the term "routinely" from the Proposal with "regularly." Additionally, the Commission provided guidance on a number of terms used under the Expressing Trading Interest. This guidance indicates that the SEC may take an expansive view of what activity is captured by the test.

"On Both Sides of the Market"

While the Final Rules clarify that the Expressing Trading Interest test requires a person's trading interest to be "on both sides of the market *for the same security*," the Commission declined to require that expressions of trading interest be simultaneous or provide a time horizon over which to evaluate single-sided expressions of trading interest. The Commission explained that "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,"[10] including in determining whether their quoting activity meets the Final Rules' "regularly expressing" standard.

"Regularly Expressing"

As proposed, the Expressing Trading Interest test would have required a person who "*routinely*" expresses trading interest at or near the best available prices on both sides to register as a Dealer. While the SEC noted that the term "routine" was "intended to capture significant liquidity

providers who express trading interests at a high enough frequency to play a significant role in price discovery and the provision of market liquidity, even if their liquidity provision may not be continuous like that of some traditional dealers,"[11] commenters expressed concern due to a lack of clarity and ambiguous nature of the term. Rather than directly addressing these concerns through a formal definition or clear guidance, the SEC replaced the term "*routinely*" with "*regularly*," indicating the change was intended to mirror the statutory text.[12] Notwithstanding the SEC's note regarding its purpose, this change may result in additional activity being captured by the Final Rules. For instance, while the term "routine" indicates activity that is common and expected, the term "regular" could include activities that, while not routine, simply occur with some frequency (contrast one's morning "routine" with "regularly" traveling for work).

The term "regularly" in the final rules will apply to a person's expression of trading interest both "within a trading day and over time."[13] This requirement is intended to distinguish persons engaged in isolated or sporadic expressions of trading interest from persons whose regularity of expression of trading interest demonstrates that they are acting as Dealers. The Commission was clear, however, that a person does not need to be "continuously expressing trading interest" to be engaging in a "regular" business; rather, whether a person's activity is "regular" will depend on the liquidity and depth of the relevant market for the security.[14]

For example, while expressing trading interest "as part of an investment strategy on a one-off basis," in a liquid market would *not* meet the requirements of the Expressing Trading Interest test,[15] in less liquid markets (e.g., where it is more difficult to execute orders or large orders can significantly impact the price of the security), "regular" would include the "possibility of more interruptions or wider spreads for the best available prices."[16]

"At or Near the Best Available Prices"

While the Expressing Trading Interest test requires that quoting activity be "at or near the best available prices on both sides of the market," the Final Rules and Adopting Release provide little guidance on this standard. Notably, statements by the SEC during the open meeting to consider the Proposal suggested that the SEC would look to the relevant facts and

circumstances to determine if expressions of trading interest are at or near the best available prices.[17]

Further, in the Adopting Release, the Commission explained that, in determining whether trading interest was expressed "at or near" the best available price, market participants should look to information typically used 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."[18]

The SEC did, however, clarify that 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 test because that trading interest, absent more, would not be "at or near the best available price."[19] Additionally, the Commission acknowledged that an adviser's fiduciary duty may require it to submit "trading interests" throughout a trading day and explained that the Final Rules have been modified such that the trading interest expressed by an investment adviser for purposes of its fiduciary duty to its clients and their its accounts would not be activity captured by the Expressing Trading Interest test, unless the investment adviser itself is the account holder or the account is held for the benefit of the investment adviser.

"Trading Interest"

The term "trading interest" means: (i) an "order" as the term is defined in Rule 3b-16(c)[20] 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.[21] The SEC indicated that the second prong of this definition is intended to account for "the various and evolving ways in which buyers and sellers of securities are brought together."[22]

"Accessible to Other Market Participants"

The phrase "accessible to other market participants" reflects the requirement that a person's trading interest must be expressed to more than one market participant to be captured under the test.[23] The SEC notes, however, that the particular method of communication or representation is not controlling and that multiple individual communications could qualify if they are communicated to more than one market participant.[24]

Primary Revenue Factor

The Commission adopted, as proposed, the Primary Revenue test, which requires a person to register as a dealer or government securities dealer if that person is "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."[25]

Revenue

While the SEC provided guidance indicating that generating the *majority* of one's revenue from price appreciation, rather than capturing the bid-ask spread, would indicate somebody was not engaged in dealer activity, the Commission failed to clarify how "revenue" should be assessed under the Final Rules or adopt a "profitability" standard in its place (as suggested by commenters).[26] However, the Commission made it clear that a person's trading strategies would not need to be profitable to bring them within the rule.[27]

Trading Venue

The term "trading venue" is intended to capture the full variety of venues on which market participants engage in liquidity-providing dealer activity, both today and as they evolve.[28] The Commission explained that the particular venue matters less than the fact that a market participant provides liquidity on it.[29]

Scope

The Adopting Release notes that the effect of a person's trading activity, rather than its stated purpose, controls in determining whether the Primary Revenue test has been met. Accordingly, cash management strategies involving government securities could inadvertently trigger the Primary Revenue test.[30]

Definition of "Own Account" & Aggregation

The Proposal would have defined the term "own account" to include both an account held by or for the benefit of such person *and* any account over which "that person exercises control or with whom that person is under common control." This definition would have incorporated the definition of "control" from Exchange Act Rule 13h-1.

Additionally, the Proposal included the concept of a "parallel account structure," which would have required separate legal entities not under common control to aggregate their activity where "one or more private funds ..., accounts, or other pools of assets ... 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."[31]

As adopted, the definition of "own account" does *not* include any account over which "that person exercises control or with whom that person is under common control."[32] Additionally, the Final Rules removed the concept of a "parallel account structure." Rather, the Commission notes in the Adopting Release that it has elected to focus on activity on an entity-by-entity basis rather than aggregating accounts across entities based on control or commonality of investment objective and strategy.[33] Accordingly, the adopted definition of "own account" no longer requires aggregating activity across accounts that constitute a "parallel account structure and is limited to any account: (i) held in the name of that person or (ii) held for the benefit of that person."[34]

Anti-Evasion

Rather than adopt the "control" or "parallel account structure" concepts, the Final Rules adopted an "anti-evasion" provision. This provision prohibits evading the Final Rules' registration requirements by either: (i) engaging in activities indirectly that would satisfy the Expressing Trading Interest or Primary Revenue Factors or (ii) disaggregating accounts.[35]

The Commission makes it clear that anti-evasion provision is intended to capture persons dividing or structuring their activity to evade the application of the Final Rules and notes that potentially evasive activity includes, but is not limited to:[36]

- Coordinating and integrating trading across commonly controlled legal entities such that no entity meets the qualitative standards;
- Using two legal entities to separately purchase and sell securities; and
- Using several legal entities to purchase and sell securities but rotating the activity across the entity in a way that none of the entities trades frequently enough to satisfy the "regular" test under either factor.

In determining whether or not a person is evading the dealer registration requirements, the Commission may consider whether:[37]

- There are information barriers to prevent sharing of information or sufficiently segregated trading,
- There are overlapping personnel across accounts or entities,
- There are separate account statements for each account, or
- There is a business purposes that demonstrates that there is no coordinated buying and selling between accounts or entities.

Notably, the Commission provided that it would generally consider management by an adviser of managed accounts that are separately owned, but follow substantially the same investment objectives and strategies, to be ordinary course business activities and thus the Commission would not impute the trading in the clients' accounts to the adviser's own account, absent an intent to evade the dealer registration requirements.[38] Notwithstanding this exclusion, it is important to recognize that whether a person has violated the anti-evasion provision will depend on an evaluation of the totality of the facts and circumstances.

No Presumption

The Final Rules include a "no presumption" provision, stating that no presumption shall arise that a person is *not* a Dealer solely because such person's activities are not captured by the adopted tests. Accordingly, the SEC could still determine that a market participant that does not trigger either of the qualitative standards is still a Dealer under applicable precedent.

Exclusions

The Proposal included an exclusion for registered investment companies and persons with less than $50 million of total assets.

A number of commenters requested additional exclusions, including exclusions for registered investment advisers and private funds. While the Commission declined to exclude investment advisers and private funds, the Final Rules expand the scope of excluded entities to add certain "Official Sector" entities[39] to the types of entities excluded from the

Proposal (i.e., a person with less than $50 million of total assets and registered investment companies).[40]

The Commission also declined to exclude crypto asset securities from the Final Rules, noting that whether or not an entity is a Dealer depends on the securities trading activities undertaken by a firm, not the type of securities being traded.[41]

Potential Impact

As part of its economic analysis, the SEC identified certain market participants that it determined *might* be captured by the Final Rules. In determining who would be impacted, the Commission looked at data from FINRA's Trade Reporting and Compliance Engine (TRACE) and Form PF.

Using TRACE data for US Treasury securities, the SEC identified firms that appeared to meet the Primary Revenue Factor by earning revenue from capturing bid-ask spreads in the market for US Treasury securities. As part of this exercise, the SEC noted that unregistered "principal trading firms" (or PTFs) were most likely to be impacted, noting their de facto role as market makers in the US Treasuries markets. Based on its analysis of TRACE data, the SEC approximated that 13-22 PTFs and four (4) private funds may be within scope of the rule.[42] The SEC was unable to estimate the number of entities that appear to meet the Expressing Trading Interest Factor because the Commission does not have sufficient data on quoting activities.

Outside of the market for Treasury securities, the SEC's economic analysis relied on Form PF disclosures regarding private funds' use of high frequency trading strategies. While the SEC acknowledged that it was unable to determine whether the self-reported HFT activities would satisfy the Expressing Trading Interest or Primary Revenue tests, it concluded that the funds most likely to be within the scope of the Final Rules were those funds with a higher percentage of their net asset value ("NAV") dedicated to HFT strategies. Accordingly, the SEC identified as likely to meet the definition of Dealer under the Final Rules twelve (12) private funds that reported at least 10 percent of their NAV as associated with HFT strategies. For clarity, this is in addition to the four (4) private funds identified through TRACE data for US Treasury securities.

Enforcement Implications for Unregistered Dealer Activity

Notably, the SEC recognized that its approach in estimating the number of potentially impacted PTFs and private funds is imperfect as the estimate is based largely on what data was available to the SEC rather than clear indicators of potential dealer activity. While the Commission's estimates are imperfect, its approach may help identify firms that are likely to be targeted in future exams.

Notably, all firms should perform a self-assessment of their trading strategies in light of the Final Rules. While firms that meet the criteria used by the SEC may want to engage in more comprehensive self-assessments, the deficiencies in the SEC's estimates mean that other firms should not assume they are outside the scope of the Final Rules.

Issues for Advisers and Funds That Register

Dealers are subject to a number of rules and requirements to which registered investment advisers, private funds and principal trading firms are not currently subject. While the scope of the Final Rules have generally been narrowed, given the ambiguity in the Final Rules, we highlight certain considerations relating to dealer registration.

SRO Membership

A dealer must register with one or more self-regulatory organizations ("SROs"), and most dealers are required to become members of FINRA.[43] SRO members are subject to the relevant SRO's rules, including a number of technical rule requirements that are not applicable to other market participants (e.g., consolidated audit trail and trade reporting obligations), and periodic examinations by the SRO.

New Issues (IPO) Restrictions

FINRA Rules 5130 and 5131 (commonly known as the FINRA "new issues" rules) restrict certain market participants from receiving shares in initial public offerings ("IPOs"), including broker-dealers, associated persons of a broker-dealer and certain persons owning a broker-dealer. If a private fund is registered as a dealer, the fund would be restricted from receiving shares in an IPO and, relatedly, certain of its owners (e.g., its limited partners) could similarly become restricted from participating.[44]

Capital Withdrawals

Dealers are subject to the net capital requirements of Exchange Act Rule 15c3-1 (the "Net Capital Rule"). Generally, the Net Capital Rule requires that dealers maintain more than a dollar of highly liquid assets for each dollar of liabilities. The Net Capital Rule highly discourages withdrawals of capital within one year of contribution, providing, generally, that any capital withdrawn within one year of contribution was *never* eligible to be treated as "good" capital for purposes of the Net Capital Rule. If a private fund (or its subsidiary) registers as a dealer, the private fund's existing liquidity terms may need to be amended in order to include all of the investors' capital as "good" capital and any such amendment is likely to require investor consent.

Change in Control Filings

FINRA rule 1017 requires that broker-dealers file an application for any change in ownership that results in one person or entity directly or indirectly owning or controlling 25 percent or more of the equity or partnership capital. While, in certain cases, closing may occur thirty (30) days after filing of such application, FINRA may impose interim restrictions that delay closing until 180 days (or longer) after filing. This could delay a private fund's ability to accept new subscriptions or process redemptions to the extent such subscriptions or redemptions require a filing of a "change in ownership" application by such private fund or its subsidiary.

Other Considerations

- Certain investors may not be permitted to invest (directly or indirectly) in the equity of a broker-dealer and may need to be redeemed from the private fund before the private fund or its subsidiary becomes a registered dealer.

- Modifying a fund's investment strategy (e.g., by moving the dealer activity out of the private fund to a new entity that is not owned by the private fund to avoid dealer registration at (or below) the private fund level) may require investor consent and also trigger investor redemption rights.

Compliance Deadline

The final rules will become effective 60 days following the date of publication of the Adopting Release in the Federal Register. The compliance date will be one year after the effective date of the Final Rules

("Compliance Period") and, in a departure from the Proposal, the Compliance Period applies to both market participants engaged in activity that meets one or both adopted tests prior to the effective date and new entrants.

Impacted persons will need to have their dealer registrations *approved* by the end of the Compliance Period (absent an extension). This represents a very short window as impacted firms will need to identify, among other things, the anticipated ownership structure, personnel and procedures. Further, while FINRA indicated it would attempt to expedite the registration process for entities impacted by the Final Rules, in our experience FINRA approval of a new membership application can easily take over six (6) months from the date of *submission*.

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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[1] "Further Definition of 'As a Part of a Regular Business' in the Definition of Dealer and Government Securities Dealer," Exchange Act Release No. 34-99477 (Feb. 6, 2024) ("Adopting Release").

[2] *See* "Further Definition of 'As a Part of a Regular Business' in the Definition of Dealer and Government Securities Dealer," Exchange Act Release No. 34-94524 (March 28, 2022), 87 Fed. Reg. 23054 (April 18, 2022) ("Proposing Release"). *See also* Schulte's previous *Alert* regarding the substance of the proposed rule, available here.

[3] Adopting Release at 30.

[4] *Id.* at 243.

[5] *Id.*

[6] *Id.*

[7] *Id.* at 30-31.

[8] *See, e.g.*, *SEC v. Almagarby*, No. 21-13755, 2024 WL 618517 (11th Cir. Feb. 14, 2024), *SEC v. Keener*, 580 F. Supp. 3d 1272 (S.D. Fla. 2022); *SEC v.*

Fierro, No. CV 20-02104 (GC), 2023 WL 4249011 (D.N.J. June 29, 2023); *SEC v. Carebourn Cap., L.P.*, No. 21-cv-2114, 2023 WL 6296032 (D. Minn. Sept. 27, 2023).

[9] *See* Adopting Release at 33. (Emphasis added)

[10] *Id.*

[11] *Id.* at 33-34.

[12] *See* Exchange Act Section 3(a)(5)(B), noting that persons who buy and sell securities "*not as a part of a regular business*" are not acting as "dealers."

[13] *Id.* at 35.

[14] *Id.* at 36.

[15] *See Id.* at 36-37.

[16] *See Id.*

[17] *See* SEC Open Meeting to Consider Whether to Adopt New Rules to Further Define the Phrase "as a part of a regular business" As Used in the Statutory Definitions of the Terms "dealer" and "government securities dealer" Under the Securities Exchange Act of 1934, in Connection With Certain Liquidity Providers, Feb. 6, 2024 available https://www.youtube.com/watch?v=zHzNDvDblzg.

[18] *See* Adopting Release at 48.

[19] *See* Adopting Release at 42.

[20] Under Exchange Act rule 3b-16, the term *order* means 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.

[21] *See* Adopting Release at 41.

[22] *Id.* at 38.

[23] *Id.* at 49.

[24] E.g., separate directed communications expressing the same trading interest.

[25] *See* Adopting Release at 21.

[26] *Id.* at 52.

[27] *See* Id.

[28] Currently, the term includes any "national securities exchange or national securities association that operates an SRO trading facility, an ATS, an exchange market maker, an OTC 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."

[29] *Id.* at 53.

[30] *Id.* at 55.

[31] *Id.* at 84

[32] *Id.* at 83. In addition, the Commission eliminated the definitions of "control" and "parallel account structure" since the corresponding language in the aggregation provisions in the Proposal has been removed.

[33] *Id.* at 88.

[34] *Id.*

[35] *See Id.* at 90.

[36] *See Id.* at 91.

[37] *See Id.* at 92.

[38] *See Id.* at 91.

[39] The Official Sector Exclusions exempts central bank, sovereign entity, or specifically identified international financial institutions from application of the Final Rules.

[40] *Id.* at 243.

[41] *Id.* at 22.

[42] *See Id.* at 105-106.

[43] *See*, e.g., the recent amendments to Exchange Act rule 15b9-1. Exemption for Certain Exchange Members Exchange Act Release No. Exchange Act Release No. 34-98202 (Aug. 23, 2023).

[44] Generally, depending on the size of the person's ownership interest and whether the person is a direct or indirect owner of the broker-dealer.

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