ALERTS

SEC Proposal to Redefine the Definition of 'Dealer' Would Cover Certain Private Funds and Private Fund Advisers

May 16, 2022

In the first quarter of 2022, the U.S. Securities and Exchange Commission ("SEC") proposed a slew of new rules and rule amendments directed at private fund managers and their investment activities. One proposal that has garnered less attention is directed at proprietary trading firms but would cover certain private funds and private fund advisers.

> Proposed Exchange Act Rule 3a5-4 ("Rule 3a5-4") would require persons "engage[d] in a routine pattern of buying and selling securities for their own account that has the effect of providing liquidity" to register as a dealer.
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> Proposed Exchange Act Rule 3a44-2 ("Rule 3a44-2," and together with Rule 3a5-4, the "Proposed Rules"), would require any person who, in four of the last six calendar months, bought or sold over $25 billion in government securities to register as a government securities dealer.[1]

The Proposed Rules exempt registered investment companies but not private funds or registered investment advisers; instead, the Proposing Release expressly anticipates that certain advisers and private funds would have to register as dealers if the Proposed Rules are adopted. In its present form, the Proposed Rules are written broadly and would capture advisers and their funds if they engage in day trading, arbitrage strategies or otherwise regularly buy and sell roughly equivalent quantities of the same or "substantially similar" securities during a day. The Proposed Rules

would require certain private funds to register as dealers if their trading activity, viewed on a legal-entity basis, constitutes Dealer Activity (defined below) and would also require certain private fund advisers to register if their trading, viewed either on a legal entity-basis or when aggregated with certain trading activity in client accounts, constitutes Dealer Activity.

Comments on the Proposed Rules should be submitted on or before May 27, 2022. Schulte Roth & Zabel is gathering feedback from our clients about the impact of the SEC's proposed rules as we prepare a comment letter.

Proposed Rule 3a5-4

Proposed Rule 3a5-4 would require, subject to limited exceptions, any person who "engages in a routine pattern of buying and selling securities for their own account that has the effect of providing liquidity" to register as a dealer.

Proposed Rule 3a5-4 identifies certain activities that would be considered to have the effect of providing liquidity to other market participants, including:

1. routinely making roughly comparable purchases and sales of the same or substantially similar securities (or government securities) in one day;

2. routinely expressing trading interests that are at or near the best available prices on both sides of the market; or

3. earning revenue primarily from capturing bid-ask spreads or from capturing incentives offered by trading venues to liquidity-supplying trading interests (collectively, "Dealer Activity").[2]

"Routine" Activity

The Proposing Release explains that while "routinely" means more than occasionally, it does not need to be continuous. With respect to "expressing trading interests," the "routinely" standard would apply to the frequency with which a person expresses two-sided trading activity both intraday and over time. Accordingly, individuals or entities that utilize strategies that express two-sided trading interest continuously throughout a trading day or that routinely express such interest during discrete timespans (*e.g.*, into the closing auction) may need to register as dealers under the Proposed Rules.

"Substantially Similar" Securities

For purposes of the Proposed Rules, the requirement that purchases and sales be of the same or "substantially similar" securities is intended to capture instances where the purchase (sale) of a security is designed to offset the risk undertaken through the sale (purchase) of another security.[3] Whether securities constitute ''substantially similar'' securities would require a facts and circumstances analysis, and would consider factors such 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.[4] Examples of "substantially similar" securities includes buying an exchange traded fund ("ETF") and selling the underlying securities that make up the ETF, buying a European call option on a stock and selling a European put option on the same stock with the same strike and maturity or buying an OTC call option on a stock and selling a listed option on the same stock with the same strike and maturity.[5] However, buying stock in one company (*e.g.*, Ford) and selling stock in another company in the same industry (*e.g.*, Chrysler) would not constitute "substantially similar" securities. Nor would buying stock and selling bonds issued by the same company.[6]

"Roughly Comparable" Purchases and Sales

Under the Proposing Release, whether a person makes "roughly comparable" purchases and sales is determined through an analysis of the net imbalance of the dollar volume, number of shares or risk profile of the same or similar securities on a given day. While the Proposed Rules do not contain a quantitative threshold, the Proposing Release suggests that a buy/sell imbalance of 20 percent or less may qualify as dealer activity and trigger a registration obligation.

Earning Revenue by Capturing Bid-Ask Spreads or Trading Venue Incentives

Proposed Rule 3a5-4 would define any trading strategy that primarily generates revenue from capturing spreads, rebates or incentives as dealer activity. The Proposing Release distinguishes routine trading from dealer activity by defining the latter as being primarily directed at earning compensation from spreads and incentives rather than compensation

that is "attributable to changes in the value of the security traded." While Proposed Rule 3a5-4 does not provide a bright-line test, the Proposing Release notes that a person who derives the *majority* of revenue from capturing spreads, rebates or incentives would likely be in a regular business of buying and selling securities for his or her own account.

"Dealer Activity" by Private Funds

Dealer registration is triggered when a person is in the business of buying and selling securities for such person's "own account." This would require any private fund to register as a dealer if its trading activity, viewed on a legal-entity basis, constitutes Dealer Activity. The Commission justifies the inclusion of private funds as a means to provide greater oversight of their trading activities as part of the Commission's overall focus on market functionality.[7]

The SEC has requested comment on the inclusion of private funds in the Proposed Rules, including whether private funds could comply with dealer requirements and also whether the Proposed Rules would cause private funds to cease or reduce investment strategies that constitute Dealer Activity and the potential impact on markets.[8]

Additional Trading Activity by RIAs and their Funds Captured by Aggregation Requirements

For registered investment advisers, the Proposed Rules adopt a broad definition of trading for one's "own account," which captures proprietary trading activity as well as certain fund trading activity based on an adviser's right to control or sell the voting securities of the private fund, an adviser's capital contributions to or rights to amounts on dissolution of the private fund or the parallel structure of the funds or accounts. Where the adviser's and/or the private funds' trading activity falls under the definition of "own account" and the private fund is not otherwise required to register based on its trading activity viewed on a legal-entity basis, the Proposing Release details that the relevant consideration is whether the aggregated trading activity constitutes Dealer Activity.

Definition of "Control" for Purposes of Evaluating Trading for One's "Own Account"

In addition to capturing advisers that engage in Dealer Activity in their proprietary trading accounts, the definition of "own account" could also capture Dealer Activity by accounts managed by the adviser.[9]

While not expressly defined in the Securities Exchange Act of 1934, as amended ("Exchange Act"), the term "own account" has historically been viewed as distinguishing between principal and agency activities (with certain principal securities activities requiring dealer registration, and certain agency securities activities requiring registration as a "broker"). The Proposed Rules would, for the first time, define the term "own account" as any account that, subject to certain exclusions, is (i) held in the name of that person or (ii) held in the name of a person over whom that person exercises *control* or with whom that person is under *common control*. The Proposed Rules would incorporate the definition of "control" from Exchange Act Rule 13h-1.[10]

Under the Proposed Rules, an adviser would be deemed to control a private fund if it (i) controls the fund through a capital contribution of 25 percent or more, (ii) has the right to receive 25 percent or more of fund assets upon dissolution, (iii) directly or indirectly has the right to control or vote 25 percent or more of the voting shares of the fund or (iv) has the power to sell or direct the sale of 25 percent or more of the voting securities of the fund.

The proposed definitions of "own account" and "control" raise a number of questions regarding the potential impact for registered investment advisers, including whether commonplace private fund structures would be viewed as being under the "control" of the adviser and therefore treated as the adviser's "own account."

Traditionally, "control" under Rule 13h has been interpreted broadly such that most advisers are deemed to control the private funds they manage.

Parallel Fund Structure

Under the Proposed Rules, accounts generally would not be deemed to be in an adviser's "own account" simply because they are managed by the same adviser. The Proposed Rules, however, include an exception for accounts that constitute a "parallel account structure" – "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." Under certain circumstances, the trading activities of accounts in a parallel account structure would need to be aggregated. As it is not uncommon for an adviser to have multiple funds that pursue the same strategy, this could result in a situation where the adviser is not required to aggregate with the private funds under its common control and management but such private funds are required to aggregate with each other.

The SEC has requested comment on the aggregation issues and how the Proposed Rules might otherwise impact advisers, private funds and other market participants based on the different corporate structures employed by such entities.

Proposed Rule 3a44-2

Proposed Rule 3a44-2 would require any person who, in four of the last six calendar months, engaged in buying and selling more than $25 billion of trading volume in government securities to register as a government securities dealer. Notably, this quantitative standard would only apply to market participants trading in government securities (*e.g.*, Treasuries), and would not apply to persons who limit their trading to NMS securities or other non-government securities.

Enforcement Implications for Unregistered Dealer Activity

Even where an adviser is not deemed to control an account over which it exercises discretion, the adviser may be subject to enforcement action where it causes the client account to engage in unregistered dealer activity.

Overview of "Dealer" Registration

Dealers are subject to a number of rules and requirements not currently applicable to registered investment advisers, private funds or principal trading firms. While we anticipate that certain market participants will adjust or curtail their fund structures and/or trading activities in order to avoid triggering dealer registration requirements, we nevertheless 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. 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 (the "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, its owners (*e.g.*, its limited partners) might similarly become restricted.

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 should *never* have been considered part of a firm's equity. Accordingly, assuming an adviser elected to register a private fund (or other vehicle) as a dealer, any investor in such fund or vehicle would likely be subject to a mandatory one-year lockup on each contribution.

If you have any questions concerning this Alert, please contact Marc E. Elovitz, Julian Rainero, Craig S. Warkol, Kelly Koscuiszka, Jennifer M. Dunn, Derek N. Lacarrubba, William J. Barbera or your attorney at Schulte Roth & Zabel.

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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. 34-94524 (March 28, 2022), 87 Fed. Reg. 23054 (April 18, 2022) ("Proposing Release").

[2] Avoiding the identified activities does *not* create a presumption that a person is not acting as a dealer under the Exchange Act.

[3] Proposing Release, 74 Fed. Reg. at 23067.

[4] *Id.*

[5] *Id.*

[6] *Id.*

[7] *Id.* at 23064.

[8] *Id.*

[9] The Proposed Rules would exclude from the rules' aggregation requirements assets and strategies that operate out of (i) a registered broker, dealer or government securities dealer or (ii) a registered investment company.

[10] Under Exchange Act rule 13h-l(a)(3), 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."

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