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The SEC Significantly Expanded Its Jurisdiction Over Securities Traders By Adopting New Dealer Rules

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I. INTRODUCTION

In the face of overwhelming and near universal industry opposition, the Securities and Exchange Commission ("SEC" or "Commission"), in a split 3-2 vote, adopted new rules designed to capture "*de facto* market makers" and regulate them as registered "dealers".[1] The adoption of the new dealer rules perhaps should not have been surprising when viewed cumulatively with the Commission's equity markets concept release,[2] a recent amendment to an obscure trading rule, the net effect of which will direct a class of new dealers into membership with the Financial Industry Regulatory Authority ("FINRA"),[3] and dealer enforcement actions applying the Commission's *de facto* market maker theory that comprises the legal principle at the center of the new rules.[4]

Presented below is: (i) a thumbnail summary of the new dealer rules – Rule 3a5-4 and Rule 3a44-2 under the Exchange Act – including the key modifications since they were proposed in 2022,[5] (ii) a compliance timeline to complete registration and obtain membership in one or more self-regulatory organizations ("SRO"), (iii) a summary of the immediate impacts on market participants captured by the dealer rules, and (iv) an analysis of how Rule 3a5-4 and Rule 3a-44 fit in the Commission's dealer/government securities regulatory regime.

II. THUMBNAIL SUMMARY OF NEW DEALER RULES

The stated purposes of Rule 3a5-4 and Rule 3a-44 are to "support market stability and resiliency and [to] protect investors by promoting the financial responsibility and operational integrity of significant liquidity providers that are acting as dealers in the securities markets [Adopting Release at p. 6 (footnote omitted)]. The effect of the rules is to expand the SEC's jurisdiction over securities and government securities traders based on a newly codified liquidity test. The Commission had previously proposed a liquidity test comprised of four parts (a three-part qualitative test and a single quantitative test for Treasury trading) all of which individually were intended as proxies of dealer status based on the Commission's perception that providing market liquidity should be a regulated function. The proposed rules' clear intended goal was to capture PTFs actively trading in the Treasury market. Certainly, as adopted, they seem to accomplish that goal.

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1 Securities Exchange Act Release No. 99477 (Feb. 6, 2024) ("Adopting Release").

2 Securities Exchange Act Release No. 61358 (Jan. 14, 2010), 75 F.R. 3594 (Jan. 21, 2010).

3 Possibly in anticipation of capturing a new class of registrants, the Commission adopted amendments to Rule 15b9-1 under the Securities Exchange Act of 1934 ("Exchange Act") to effectively shepherd into FINRA membership principal or proprietary trading firms ("PTFs") newly registering with the SEC. Previously, Rule 15b9-1 exempted from FINRA membership PTFs (registered as dealers but not FINRA members) unlimited proprietary trading on any exchange of which they were not a member or off-exchange in other venues so long as they were a member of at least one exchange, had no customer accounts, and traded through another broker-dealer. The SEC eliminated the exemption from FINRA membership in August 2023, less than six months prior to adopting the new dealer rules. Securities Exchange Act Release No. 98202 (Aug. 23, 2023), 88 F.R. 61850 (Sept. 7, 2023).

4 The SEC's Enforcement Division actively pursued unregistered dealer actions in a series of microcap convertible debt securities cases. *See, e.g., SEC v. Fiero*, Civ. Action 20-02104 (GC) (D. New Jersey) (June 29, 2023).

5 *See* Securities Exchange Act Release No. 94524 (March 28, 2022), 87 F.R. 23054 (Apr. 18, 2022).

However, their scope goes beyond the Treasury market and PTFs, and extends to the equity markets and market participants other than PTFs, such as actively traded private funds satisfying the Commission's revised liquidity tests and potentially other active market participants (*e.g.,* bank collective or common trust funds) previously believed to be exempt traders permissibly outside of the Exchange Act's broker-dealer regulatory regime.

The SEC modified the rules' proposed liquidity tests by eliminating one of the qualitative tests and the quantitative test for Treasury securities.[6] The eliminated qualitative test had a far-reaching impact and conceivably could have captured traders that "routinely" hedged positions or that "routinely" sought arbitrage opportunities, as examples of some of the traditional portfolio managements functions that were treated as dealer activity. The rules instead codify a new two-part liquidity test that cumulatively or individually identifies a regular dealer business as a market participant that:

- Regularly expresses trading interests that are at or near the best available prices on both sides of the market for the same security and that are communicated and represented in a way that makes them accessible to other market participants ("Trading Test"); or
- Earns revenue primarily by capturing the bid-ask spreads, by buying at the bid and selling at the offer, or receiving any incentives offered by trading venues to liquidity-supplying trading interests ("Revenue Test").

The SEC also eliminated complex aggregation and attribution principles that would have applied the liquidity tests across holding company structures. Instead, the scope in the final rules is more streamlined and applies to trading accounts in the name or for the benefit of a market participant alone. The Commission instead adopted anti-evasion proscriptions to replace the proposed aggregation and attribution principles.

The new rules slightly expand available exemptions. Previously, small market participants (those having or controlling assets of less than $50 million) and investment companies registered pursuant to the Investment Company Act of 1940 ("1940 Act") were expressly exempted. The SEC retained the exemption for small participants and registered funds and added to the final rules exemptions for central banks, sovereign entities (federal, state, and international central governments), but not sovereign wealth funds, and specified international financial institutions that might otherwise be captured by the Trading Test and/or the Revenue Test.

In a heavily conditioned economic analysis, the SEC estimated that the new rules would affect 43 market participants characterized as PTFs and hedge funds. The Commission's analysis, however, did not apply the Trading Test to arrive at an estimate of firms impacted by the new rules because of unavailable data. Nor does the estimate cover all markets. Rather, the impact analysis only includes application of the Revenue Test [Adopting Release at p. 104] and not in all trading venues. Therefore, the scope of the impact analysis here seems significantly inconclusive and the total economic impact and number of market participants underreported.

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6 The SEC eliminated the test that would find dealer activity if a firm "routinely making roughly comparable purchase and sales of the same securities/government securities in a day." It also eliminated the quantitative test for Treasury trading if trading in each of four out of the last six months constituted more than $25 billion of the trading volume of government securities. This may have the effect of eliminating the capture of, for example, corporate treasury functions or insurance company general account investing and trading.

III. EFFECTIVE DATE, COMPLIANCE DATE, AND FIRM CONTACT

The precise deadline for registration currently is unknown and will not be known until the Adopting Release is published in the Federal Register. As drafted, market participants captured by the new dealer rules will have one year to complete registration and SRO membership from the effective date of the rules. The effective date of the rules will be 60 days from publication in the Federal Register.

We encourage you to contact C. Dirk Peterson at dpeterson@mcintyrelf.com or (202) 659-3905 with any questions on this Legal Alert, the compliance date after publication in the Federal Register, or for more information regarding the regulatory impacts of the Commission's new dealer rules.

IV. IMMEDIATE IMPACT

The immediate impact of the new dealer rules is the registration of previously exempt traders with the SEC and the membership of those traders in one or more SROs, such as FINRA and/or national securities exchanges. As noted above, firms must at a minimum become members of FINRA because of the SEC's recent change to Rule 15b9-1 that will require PTFs to become FINRA members. Although FINRA has committed to an expedited and streamlined membership process, prudence dictates that firms should plan on a six-month administrative process for membership approval from the date of filing its membership application with FINRA's MAP group.

Very generally, dealer registration will subject dealers to Exchange Act and FINRA rules and the following obligations:

- Maintenance of minimum net capital ($100,000 for dealers with no customers)
- Observance of leverage and capital withdrawal limits
- Obligations to establish supervisory and regulatory compliance programs
- Requirements to appoint an independent public accountant
- Responsibility for periodic financial filings, including year-end audited financial statements
- Maintenance and preservation of books and records
- Cooperation with periodic regulatory examinations
- Registration and qualification of key personnel, such as two Principals, a Financial Operations Principal, and a Chief Compliance Officer
- Payment of annual assessments based on gross revenues and trading activity, such as (i) SEC Section 31(b) assessments, (ii) FINRA gross income assessments, trading activity fees, and personnel registration fees, and (iii) the Securities Investor Protection Corporation fund annual assessments.

State law registration and personnel qualification issues also will need to be considered in any strategic and regulatory planning.

IV. RULES 3a5-4 AND 3a44-2

A. Dealer Registration and Status

Section 15 of the Exchange Act grants the SEC authority to register and to regulate market participants performing a dealer business.[7] Section 3(a)(5) of the Exchange Act defines a dealer, in pertinent part, as "any person engaged in the business of buying and selling securities . . . for such person's own account through a broker or otherwise."[8] For participants in the Treasury market, Section 15C of the Exchange Act grants the SEC the authority to register and regulate market participants performing a dealer business in government securities.[9] Section 3(a)(44) of the Exchange Act defines a "government securities dealer" generally to mean "any person engaged in the business of buying and selling government securities for his own account, through a broker or otherwise . . . ."[10] Each definition excludes persons that buy and sell securities for their own accounts but not as part of a "regular business" – an exclusion that distinguishes traders from dealers.[11]

The new dealer rules significantly modify the understanding of the trader exclusion to capture de facto market makers with a new liquidity test. Although PTFs trading in the Treasury market seemed the primary focus, Rule 3a5-4 reaches the equity markets and the rules' scope is not limited to PTFs but can conceivably capture private investment funds, such as hedge funds, bank-sponsored collective or common trust funds, and potentially a class of inadvertent dealers netted by the Trading Test or either or both of the elements of the Revenue Test.

B. Scope of New Dealer Rules

Final Rule 3a5-4 and Rule 3a-44 apply to market participants that buy and sell securities/government securities for their own accounts as a regular business to the extent they engage "in a regular pattern of buying and selling securities [or government securities] that has the effect of providing liquidity to other market participants," based on the Trading Test *or* one of two elements of the Revenue Test noted below.

1. Trading Test

Regularity

The Trading Test identifies a regular dealer/government securities dealer business if a market participant regularly expresses trading interests that are at or near the best available prices on both sides of the market for the same security/government security and that are communicated and represented in a way that makes them accessible to other market participants.

6 15 U.S.C. §78o.

7 15 U.S.C. §78c(a)(5)(A).

8 915 U.S.C. §78o-5. Government securities dealer regulation establishes shared jurisdiction that divides regulatory authority among the Department of Treasury, the SEC, FINRA, and banking regulators to regulate government securities dealers. Specialized government securities dealers are subject to financial responsibility and recordkeeping rules prescribed by

9 Treasury. *See* 17 C.F.R. §402 (minimum net capital); 17 C.F.R. §403.5 (custody requirements).; and 17 C.F.R. §§404.2 and 404.3 (recordkeeping and records preservation).

10 15 U.S.C. §78c(a)(44). Government securities include, not only Treasury securities (*e.g.,* direct obligations of, and/or securities guaranteed by, the United States), but also the securities of government-sponsored agencies and enterprises. *See* 15 U.S.C. §77c(a)(42).

11 15 U.S.C. §78c(a)(5)(B); and 15 U.S.C. §78c(a)(44)(A). The trader-dealer distinction has largely applied based on a multifactor test that looks whether a market participant: (1) advertises or otherwise holds itself out as willing to buy for or sell securities from its own account on a continuous basis; (2) purchases or sells securities as principal from or to customers; (3) carries a dealer inventory in securities; (4) quotes a market in securities; (5) provides investment advice as an incidental service; (6) extends or arranges for the extension of credit in connection with securities transactions; (7) runs a matched book of repurchase and reverse repurchase agreements; (8) uses an interdealer broker for securities transactions; (9) lends securities to customers; (10) issues or originates securities; (11) guarantees contract performance or indemnifies parties for any loss or liability from the failure of a securities transaction to be successfully consummated; and (12) participates in a selling group or acts as an underwriter. *See, e.g., Acqua Wellington North American Equities Fund, Ltd.,* SEC No-Action Letter (pub. avail. July 11, 2001) (confirming the trader status of fund even though the fund was required to be disclosed as a statutory underwriter). Neither the SEC nor the staff has identified any single factor or combination of factors as definitive of a dealer business, and our experience is that the industry weighs and balances these factors in combination, such that no single factor determines if it is more likely than not that a trader crosses an albeit imprecise line into dealer status.

Elements of the Trading Test remain imprecise, such as the meaning of “regular,” and its application in securities and markets with different market liquidity and depth. According to the SEC, an expression of continuous trading interests, although satisfying the Trading Test, is not the sole expression of trading interests. Under the rules, a trading interest need not satisfy the higher bar of continuous quoting but can be something less frequent. The SEC volunteered few clear examples but did unambiguously conclude that “significant market intermediaries” that use automated, algorithmic trading strategies that generate a high volume of orders in high frequency trading perform regular expressions of trading interests under the Trading Test and, therefore, conduct a regular dealer business [Adopting Release at p. 37]. According to the SEC, these trading strategies create “critical sources of liquidity” that should be subject to dealer regulation. Additionally, the SEC noted that hedge fund trading strategies, “such as those that involve automated or high-frequency trading . . ., could meet the final rules’ definition of dealing [Adopting Release at p. 112], as could certain passive market making strategies [Adopting Release at p. 37].

Trading Interests

The Trading Test does not turn solely on the existence of firm or continuous bid-ask quotes. The SEC intends a broader reach that would include an “order” under the definition in Rule 3b-16(c) under the Exchange Act or any non-firm indication of a willingness to buy or sell a security and either quantity, direction (buy or sell), or price. The scope includes the use of streaming quotes or request for quotes.

Both Sides of the Market

Trading interests on both sides of the market means a market participant must buy and sell securities, although the expression at the bid-ask need not be simultaneous because, according to the Commission, a simultaneous requirement would exclude market participants that were *de facto* market makers because they are significant sources of liquidity and would not adequately account for the variety of securities, trading volume, and market liquidity [Adopting Release at p. 47]. In short, the SEC viewed a simultaneous bid-ask requirement as too narrow.

2. Revenue Test

Even if the Trading Test does not capture a market participant, a dealer includes a market participant that satisfies either of the two elements based on recognizing revenues primarily from the bid-ask spread or receiving any incentives from trading venues for acting as a liquidity maker. The Revenue Test prescribes no bright-line test, although the SEC stated that “‘if a person derives the majority of its revenue from either of the sources described in the [Revenue Test], it would likely be in a regular business of buying and selling securities or government securities for its own account’” [Adopting Release at p. 52, fn. omitted].

3. Exemptions

The final rules retained the exemption for small market participants having or controlling assets of less than $50 million and registered investment companies. The SEC expanded the exemption to add central banks, governmental entities, and specified international financial institutions, such as the International Monetary Fund and International Finance Corporation. The SEC expressly declined to add investment advisers or private investment funds excluded from the 1940 Act, such as hedge funds, bank collective or common trust funds, or pension plans.

V. CONCLUSIONS

At the open meeting Commissioner Peirce mentioned several times that the staff still had much work ahead of it in understanding how the new rules would apply, particularly how substantive dealer rules will impact existing business models and whether these new registrants can legitimately comply with the SEC's net capital rule and leverage limits. The staff did not seem to have clear answers on the impacts of the net capital rule or even on the number of market participants potentially advertently or inadvertently captured by the new dealer rules.

We expect to provide periodic updates as these rules become effective and as the compliance date approaches.

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