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Dealer Rules Face Turbulent Start: Private Funds Industry Sues The SEC

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SUMMARY

As widely anticipated, the private funds industry sued the Securities and Exchange Commission ("SEC") seeking the invalidation and the postponement of the compliance date of recently adopted dealer rules [*National Association of Private Fund Managers v. SEC*, Case No. 4:24-cv-00250 (N.D. Tex., Ft. Worth Div.) (March 18, 2024)]. The suit, filed in the business friendly Fifth Circuit, joins another suit against the SEC also seeking to vacate recently adopted private fund adviser rules.

To summarize, the SEC adopted the controversial dealer rules on February 6, 2024 over universal industry objection [Securities Exchange Act Release No. 99477 (Feb. 6, 2024)]. The rules seek to define a regular dealer business based on a newly codified *de facto* liquidity principle to the extent 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 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 complaint characterizes the rules as "so overbroad, so lacking any limiting principle, and so 'clearly a misreading of the statute,' that, by the [SEC's] own admission, it would mean that everyone from a mutual fund to the Federal Reserve Bank of New York has been operating as an unregistered "dealer"—a felony, 15 U.S.C. §§ 78o(a)(1), 78ff—since the 1930s" [citations omitted]. According to the complaint, the imprecision of the Trading Test and the Revenue Test, along with the flawed economic impact analysis, renders the rules in violation of authority granted to the SEC under the Securities Exchange Act of 1934 ("Exchange Act") and makes them arbitrary and capricious, in excess of statutory authority, and unsupported by substantial evidence in violation of the Administrative Procedures Act ("APA").

Several of the arguments benefit market participants other than private funds and their advisers, such as proprietary trading firms and bank collective and common trust funds (collectively, the "Traders"), namely, unlike registered dealers, private funds and the other Traders have no customers and would be forced to significantly change their business operations to comply. Despite Chairman Gensler's casual disregard for the customer argument at the Open Meeting, the Exchange Act's dealer registration and regulatory regime is structured primarily

for the protection of customers via financial responsibility rules, self-regulatory organization ("SRO") sales practice rules, the application of the Security Investor Protection Act, and membership in the Securities Investor Protection Corporation, including the mandatory annual fee assessments for the protection of customers.

Of particular vulnerability cited in the complaint was the SEC's economic impact analysis, which clearly was incomplete and underreported the market impact of the rules. The complaint revealed a primary flaw of the economic analysis because the SEC applied only one of the tests (the Revenue Test) to measure the impact, and just for a single market. The SEC was unable to effectively apply the Trading Test at all, thus rendering the market impact findings significantly underreported. In short, the SEC had no clear or accurate sense of the reach of the dealer rules. That, along with the imprecision and potentially inconsistent application of the Trading and Revenue Tests, makes the dealer rules fatally overly broad according to the complaint. The complaint highlighted the failure of the market analysis to adequately measure the very possible degradation of market liquidity, not only in the secondary trading market, but the primary initial public offering market because an expanded class of dealers would be prohibited from participating in "hot-issue IPOs".

A consistent criticism of the SEC's recent rulemaking has been its persistent refusal to analyze the cumulative effects of the many rules proposed and adopted over the past two years. Commenters made these arguments during the comment period for the dealer rules. Similarly, Congress has made these arguments at SEC oversight hearings, including most recently at today's hearing on potential SEC regulatory overreach [House Financial Services Committee, Capital Markets Subcommittee, "SEC Overreach: Examining the Need for Reform" (March 20, 2024)]. The complaint presented these arguments in support of vacating the rules and postponing their compliance date.

CONTACT INFORMATION

We will be following this suit as it unfolds. For more information, do not hesitate to contact C. Dirk Peterson at dpeterson@mcintyrelf.com for more information.

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