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SEC Proposes New Rules Defining "Dealer" Status: Proposal Seeks to Clarify When Unregistered Firms Engaged in Market-Making and Liquidity-Providing Activities May Need to Register as Dealers[1]

APRIL 6, 2022

On March 28, 2022, the Securities and Exchange Commission (SEC) proposed new Rules 3a5-4 and 3a44-2 under the Securities Exchange Act of 1934 (Exchange Act) (collectively, the Proposed Rules). The Proposed Rules seek to clarify certain aspects of the definitions of "dealer" and "government securities dealer."[2] In particular, the SEC seeks to further define the phrases "as a part of a regular business" and "own account," as used in the statutory definitions of "dealer" and "government securities dealer."[3] As further explained below, the definitions of these phrases have been key for certain market participants in determining that registration as a "dealer" was not required.[4]

In explaining the basis for the Proposed Rules, the Proposing Release cites the emergence of certain unregistered market participants that "play an increasingly significant liquidity-providing role in overall trading and market activity" in the securities markets and U.S. Treasury securities markets.[5] In the SEC's view, because these participants are not registered, "investors and the markets lack important protections."[6] Accordingly, the SEC believes that the identification and

[1] Further Definition of "As a Part of a Regular Business" in the Definition of Dealer and Government Securities Dealer, Release No. 34-94524 (the "Proposing Release"). The Proposing Release is available here.

[2] 15 U.S.C. § 78c(a)(5); 15 U.S.C. § 78c(a)(44).

[3] *See id.*

[4] Unless otherwise indicated, for purposes of this Alert, references to "dealer" activity apply both with respect to "dealers" and "government securities dealers" under Sections 3(a)(5) and 3(a)(44) of the Exchange Act, respectively.

[5] Proposing Release at 3.

[6] *Id.* at 4.

registration of these market participants as dealers would "provide regulators with a more comprehensive view of the markets through regulatory oversight" and would enhance market stability and investor protection.[7]

To clarify when certain liquidity-providing and market-making activities could trigger dealer status, the Proposed Rules establish a qualitative standard that would apply to market participants buying and selling any security and a quantitative standard that would apply only to market participants buying and selling government securities. The Proposing Release states that the following market participants, among others, could trigger the new "dealer" definitions in the proposals if they meet the quantitative or qualitative standards: proprietary trading firms (or PTFs), private funds (including hedge funds) and investment advisers.[8] Persons who meet the definitions of dealer would be required to register with the SEC as a broker-dealer and become a member of a self-regulatory organization ("SRO") (absent an applicable exemption).

Section I of this client alert provides background on the historic "Dealer/Trader" distinction that many market participants—including PTFs, hedge funds, and investment advisers—have relied on to avoid triggering "dealer" status. Section II, in turn, discusses the SEC's new proposals and standards for determining when market participants may trigger these definitions.

The SEC has requested comments on the Proposed Rules within 60 days following the publication of the Proposing Release on the SEC's website (i.e., May 27, 2022) or 30 days following publication of the Proposing Release in the Federal Register, whichever period is longer.

I. Background on the "Dealer"/"Trader" Distinction, Which Market Participants Have Historically Relied on to Avoid "Dealer" Status When Trading for Their Own Accounts.

Under both the current "dealer" definitions in the Exchange Act, a person acts as a dealer when it "is engaged in the business of buying and selling securities or government securities," respectively, for its own account as part of a "regular business." A person who meets the definition of "dealer" is generally required to register with the SEC absent an available exemption and become a member of an SRO.[9]

Regulators, courts and market participants have historically distinguished between "dealers" (who are "engaged in the business of buying and selling securities for their own account as part of a regular business") and "traders" (who buy and sell securities but not "as a part of a regular business"). This distinction is commonly known as the "dealer"/"trader" distinction or the "trader

[7] *Id.*

[8] *Id.* at 12–14. Registered investment companies would be excluded.

[9] 15 U.S.C. § 78o; 15 U.S.C. § 78o–5.

exclusion." A trader is not required to register with the SEC or become an SRO member on account of that activity.

Whether a person is a dealer or a trader is highly fact-specific and involves an analysis of the relevant facts and circumstances. Because of the absence of a bright-line test, the exact parameters of the trader exclusion have long existed in a gray area. Over the years, the SEC and courts have identified a number of factors that might indicate a person may be engaged in dealing "as a part of a regular business," including acting as a market maker, a de facto market maker (whereby market professionals or the public look to the firm for liquidity), or a liquidity provider by trading in a manner designed to profit from spreads or liquidity incentives, rather than with a view toward appreciation in value of a security (an indicia of trader status).[10]

Many PTFs and other market participants that regularly trade for their own accounts rely upon the trader exclusion to support the conclusion that they need not register as a dealer. However, in the Proposing Release, the SEC expressed concern that certain market participants relying on this exclusion may be functioning as dealers. Specifically, the Proposing Release states that with the proliferation of electronic and algorithmic trading over the past several decades, securities and government securities market structure no longer resembles the markets that existed when the trader exclusion was first conceived. The Proposing Release further notes that unregistered firms, such as PTFs, now play a much larger role in providing liquidity in the securities markets and do so in a manner that was historically reserved for registered dealers.[11]

If adopted, the Proposed Rules would require dealer registration of any firm that engages in liquidity-providing activities "as a part of a regular business," regardless of the firm's label or status, in response to the emergence of unregulated market participants that play an integral role in price discovery and market liquidity.[12] The Proposed Rules are intended to resolve the "uneven application of regulatory oversight of significant liquidity providers [that] makes it difficult for regulators and market observers to detect, investigate, understand, or address market events."[13]

As stated above, the Proposed Rules would not only apply to PTFs but also would apply more broadly to any market participant triggering the quantitative or qualitative standards, including private funds and investment advisers. Moreover, to the extent a digital asset is a security or a government security within the meaning of the Exchange Act, persons trading these instruments

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[10] *See, e.g.*, Definition of Terms in and Specific Exemption for Banks, Savings Associations, and Savings Banks Under Sections 3(a)(4) and 3(a)(5) of the Securities Exchange Act of 1934, 67 Fed. Reg. 67496, 67498–67500 (Nov. 5, 2002); *SEC v. River North Equity LLC*, 415 F. Supp. 3d 853, 859 (N.D. Ill. 2019); *SEC v. Big Apple Consulting USA, Inc.*, 783 F.3d 786, 809-10 (11th Cir. 2015); *In re Sodorff*, 50 S.E.C. 1249, 1992 WL 224082, at *5 (Sep. 2, 1992).

[11] Proposing Release at 45.

[12] Proposing Release at 46.

[13] Proposing Release at 10.

that meet the quantitative or qualitative standards also could be deemed dealers under the Proposed Rules.[14]

II. The Proposed Rules Would Establish Qualitative and Quantitative Standards for Distinguishing Between "Dealers" and "Traders."

The Proposed Rules would establish a qualitative standard for determining whether a person is engaged in dealer activity "as a part of a regular business." The Proposed Rules also would establish an alternative quantitative standard that applies only to government securities.

A. Qualitative Standard for Determining Dealer Status.

The qualitative standard for when a person is engaged in dealer activity "as a part of a regular business" would be met when such person "[e]ngages in a routine pattern of buying and selling securities [or government securities] that has the effect of providing liquidity to other market participants."[15] The SEC has proposed three types of activities that would trigger this definition:

- routinely making roughly comparable purchases and sales of the same or substantially similar securities (or government securities) in a day; or
- routinely expressing trading interests that are at or near the best available prices on both sides of the market and that are communicated and represented in a way that makes them accessible to other market participants; 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 interests.[16]

The Proposing Release parses each type of activity by defining the terminology used within, as we describe below.

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

"Routinely"—"routinely" means "more frequent than occasional but not necessarily continuous" and relates to the frequency of the activity both intraday and across time.[17] This is different from the definition of frequency in the context of "market makers," where the frequency with which trading or

[14] Proposing Release at 13.

[15] Proposed Rule 3a5-4(a)(1); Proposed Rule 3a44-2(a)(1).

[16] Proposed Rule 3a5-4(a)(1)(i)-(iii); Proposed Rule 3a44-2(a)(1)(i)-(iii).

[17] Proposing Release at 48-49.

quotation activity would need to occur to be deemed market maker activity is instead focused on whether such activity was on a "regular" or "continuous" basis.[18]

"Roughly comparable"—"roughly comparable" means "similar enough, in terms of dollar volume, number of shares, or risk profile, to permit liquidity providers to maintain near market-neutral positions by netting one transaction against another transaction."[19] There is no bright-line test for comparability; the Proposing Release notes that the purchases and sales "need not be exactly the same" but would be considered "roughly comparable" where they "fall within a reasonable range that generally would have the effect of offsetting one transaction against the other."[20]

"Same or substantially similar"—securities that are the "same" are "securities of the same class and having the same terms, conditions, and rights," such as securities with the same CUSIP.[21] Whether securities are "substantially similar" would be based on a facts and circumstances analysis; such analysis would take into account, for example, 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.[22]

2. Routinely expressing trading interests that are at or near the best available prices on both sides of the market and that are communicated and represented in a way that makes them accessible to other market participants.

"Routinely"—"routinely" follows the same meaning as under paragraph (a)(1)(i) of the Proposed Rules, as described above.

"Trading interest"—the term "trading interest" is intended to capture a broad scope of activity that includes traditional quotations but also is intended to capture non-firm trading interest as well as "new and developing quoting equivalents, and the orders that actually result in the provision of liquidity."[23] This is consistent with the SEC's recent proposal to expand the definition of "exchange" to include "communication protocol systems" that offer the use of non-firm trading interest and

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[18] *See, e.g.*, 15 U.S.C. 78c(a)(38) (defining "market maker").

[19] Proposing Release at 50.

[20] *Id.* Although there is no bright-line test, for purposes of the economic analysis of the Proposed Rules, the SEC assumed a daily buy-sell imbalance between two identical or substantially similar securities, in terms of dollar volume, below 10% or, alternatively, 20% may be indicative of purchases and sales that are "roughly comparable."

[21] Proposing Release at 52.

[22] Proposing Release at 53. The Proposing Release also identifies a non-exhaustive list of securities that generally would and would not be considered "substantially similar" (*e.g.*, a 4.5-year maturity Treasury security is substantially similar to a 5-year Treasury security, but the stocks of two companies in the same industry are not substantially similar).

[23] Proposing Release at 57.

protocols to bring together buyers and sellers of securities.[24] Thus, as proposed, non-firm trading interest (e.g., requests for quotes) submitted by PTFs and others at or near the best quoted prices would be relevant in determining whether such person meets the definition of a dealer.

"At or near best available prices on both sides of the market"—this phrase is intended to capture the activities of liquidity-providing dealers, which "help determine the spread between the best available bid price and the best available ask price for a given security."[25]

3. 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 interests.

Importantly, the Proposed Rules use the phrase "earn revenue"—rather than, for example, "profit from"—to make clear that a person's trading strategies would not need to be profitable to bring them within the scope of the Proposed Rules.[26] The Proposed Rules implicate not only bid-ask spreads but also trading venue incentives, which could include, among other things, compensation in the form of exchange rebates from "maker-taker" venues. In the Proposing Release, the SEC notes that a major source of revenue for market makers and other liquidity providers is explicit liquidity-compensation arrangements, and that many exchanges in the equities markets have adopted a "maker-taker" pricing model to compensate (and thereby attract) liquidity providers.[27] The SEC further notes that "PTFs engaging in passive market making, for example, earn revenue primarily from the provision of liquidity, specifically 'by buying at the bid and selling at the offer and capturing any liquidity rebates offered by trading centers to liquidity supplying orders.'"[28] Accordingly, the Proposed Rules would cover these compensation arrangements.

"Trading venue"—"trading venue" is intended to have the same meaning as in the 2022 ATS Proposal: "a 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] This definition is intended to be broad; the SEC

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[24] *See* Amendments Regarding the Definition of "Exchange" and Alternative Trading Systems (ATSs) That Trade U.S. Treasury and Agency Securities, National Market System (NMS) Stocks, and Other Securities, 87 Fed. Reg. 15496, 15505 (Mar. 18, 2022) (the "2022 ATS Proposal") ("The Commission believes that... the use of a message that identifies the security and either the quantity, direction, or price would provide sufficient information to bring together buyers and sellers of securities because it allows a market participant to communicate its intent to trade and a reasonable person receiving the information to decide whether to trade or engage in further communications with the sender."). You can read more about the SEC's 2022 ATS Proposal here.

[25] Proposing Release at 58.

[26] Proposing Release at 62.

[27] *Id.* at 61.

[28] *Id.* at n. 88.

[29] *See* 2022 ATS Proposal at 15540 (Mar. 18, 2022).

stated that "[t]he Proposed Rules are designed to capture dealer activity wherever that activity occurs, whether on a national securities exchange, an ATS, a Communication Protocol System, or another form of trading venue."[30]

B. Quantitative Standard for Government Securities

In addition to the qualitative standard, the SEC also proposed a quantitative standard that would apply only to government securities activity. A person would be considered to be engaged in government securities dealing as a part of a regular business where such person is, for its own account, "[i]n each of 4 out of the last 6 calendar months, engaged in buying and selling more than $25 billion of trading volume in government securities."[31]

C. Exceptions From the "As a Part of a Regular Business" Thresholds

The SEC has stipulated two exceptions from the Proposed Rules. The Proposed Rules would not apply to:

- "[a] person that has or controls total assets of less than $50 million;" or
- "[an] investment company registered under the Investment Company Act of 1940."[32]

Importantly, the asset-based exception is not absolute and is not intended to function as a safe harbor from the statutory definition of "dealer." The SEC cautioned that even if a person meets the criteria for such exception, they could still be deemed to be a dealer—such a determination would remain a facts-and-circumstances analysis to which existing applicable interpretations and precedent will continue to apply.[33]

D. Definition of "Own Account"

Unlike a broker, which effects transactions "for the accounts of others," a dealer buys and sells securities "for its own account." The Proposed Rules would define the term "own account" to mean, subject to certain exclusions, an account held in the name of the dealer or a person over whom that dealer exercises control or with whom the dealer is under common control or an account held for the benefit of such persons.[34] "Control" has the same meaning as in Rule 13h-1 under the

[30] Proposing Release at 63.

[31] Proposed Rule 3a44-2(a)(2).

[32] Proposed Rule 3a5-4(a)(2)(i); Proposed Rule 3a44-2(a)(3)(i).

[33] Proposing Release at 36-37.

[34] Proposed Rule 3a5-4(b)(2); Proposed Rule 3a44-2(b)(2)(i).

Exchange Act.[35] With respect to the control provision, the definition excludes several categories of accounts that would be viewed as the dealer's "own account":

- an account in the name of a registered broker, dealer, government securities dealer, or investment company;
- with respect to an investment adviser, an account held in the name of a client of the adviser (unless the adviser controls the client as a result of the adviser's right to vote or direct the vote of voting securities of the client, the adviser's right to sell or direct the sale of voting securities of the client, or the adviser's capital contributions to or rights to amounts upon dissolution of the client); and
- With respect to any person, an account in the name of another person that is under common control with that person solely because both persons are clients of an investment adviser registered under the Investment Advisers Act of 1940 unless those accounts constitute a "parallel account structure."[36]

E. Relevance to Digital Asset Trading and Platforms

In the Proposing Release, the SEC explicitly states that digital assets that are securities or that are government securities are within the scope of the Proposed Rules.[37] If the Proposed Rules are adopted, digital asset trading firms and decentralized finance (DeFi) market participants, such as automated market makers, will need to consider whether their activities with respect to digital asset securities implicate the dealer registration requirement.

[35] 17 C.F.R. § 240.13h-l ("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.").

[36] Proposed Rule 3a5-4(b)(3); Proposed Rule 3a44-2(b)(3). Paragraph (b)(4) of the Proposed Rules would define "parallel account structure" to mean "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."

[37] Proposing Release at n. 36 ("Proposed Rule 3a5-4 would apply to securities as defined by Section 3(a)(10) of the Exchange Act, and proposed Rule 3a44-2 would apply to government securities as defined by Section 3(a)(42) of the Exchange Act, including any digital asset that is a security or a government security within the meaning of the Exchange Act.").

F. Compliance Period

At this time, the SEC is proposing to provide market participants a one-year compliance period from the effective date of any final rules, for a firm that is operating prior to the effective date.[38]

III. Conclusion

The Proposed Rules seek to clarify the long-standing distinction between dealers and traders with respect to market-making and liquidity-providing activities that in today's securities markets often involve unregistered firms. If the SEC adopts the Proposed Rules, previously unregistered PTFs and other market participants acting as liquidity providers will need to consider whether they are required to register as dealers and, if so, register with the SEC as dealers and become members of an SRO. Broker-dealer registration implicates many regulatory requirements, such as rules relating to financial responsibility, recordkeeping, financial condition reporting, risk oversight, and large trader reporting, as well as SEC and SRO examination, inspection, and enforcement for compliance with applicable federal securities laws and SRO rules.

[38] Proposing Release at 34.

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