Katten Partners Examine New 'Dealer' Definitions and What It Means for Hedge Funds

May 15, 2024

Partners and Broker-Dealer Regulation Co-Chairs Wayne Aaron and Susan Light spoke with *Hedge Fund Law Report* on the Securities and Exchange Commission's (SEC) updated definitions of "dealer" and "government securities dealer" under the Securities Exchange Act of 1934, which may require some hedge funds to register as dealers.

While the SEC estimates that only 12 hedge funds will be impacted by this change, Wayne suggests that number may be underestimated. He stated, "The SEC says only a certain number of private funds will be impacted, but that's easy to say at the outset. We don't know what's going to happen in the future, particularly as the interpretation of the Rules evolves. Regulation is replete with examples of rules that were described at adoption as 'limited in scope' but later were interpreted and applied much more broadly."

Regarding the SEC's decision not to exclude registered investment advisers (RIAs) and private funds from the registration requirement, Sue noted, "The SEC, along with FINRA and the exchanges, has direct responsibility for and oversight of one of the biggest market participants: broker-dealers. Here, the SEC sees other entities — whether it's one or 800 of them — that are equally impacting the market but are outside of the same regulatory regime. The SEC is interested in regulating and bringing into the fold any market participant that can influence the market. So, even if not many private funds will be impacted, the SEC believes those that are impacted are the ones affecting the market."

Wayne added that one potential outcome is that hedge funds could decide to leave the market rather than register as a dealer. "A fund could change its strategy and decide not to engage in the conduct that would otherwise give rise to regulation, even if that conduct arguably benefitted the market by providing liquidity. If anyone retreats from the market and that liquidity is no longer available, that's problematic for the participants that would have been on the other side of the market and now no longer have access to that liquidity. That's the fear."

Hedge fund managers must now assess whether their funds fall under the new definitions and decide whether to register as a dealer or modify their funds or strategies to avoid this requirement. Funds affected likely include those engaging in high-frequency trading; using automated trading algorithms; making a market on both sides of the market; engaging in some event-driven trading strategies and being active on both sides, depending on the event; and using order book strategies, taking both sides of the order book at the same time. Sue adds, "Depending on how volatile the market is, some arbitrage strategies could be pulled in as well." Wayne advised, "All funds engaging in those types of strategies should evaluate their activity. They won't necessarily be caught up in the Rules if they engage in one of those strategies, but they need to assess their activity – and the frequency and magnitude of that activity – in light of the new dealer definition."

Both urged hedge fund managers not to wait until the April 29, 2025, deadline to implement changes needed for compliance. Sue recommended, "Fund managers shouldn't sit back and wait to see whether the SEC extends the deadline. The only way managers can complete the preparation and registration within a year is to get started right away." Wayne agreed, "Certainly, compliance with the Rules can be done in a year, but it requires a lot of triage analysis and then substantive work."

"Implications of New Dealer Definition for Hedge Funds (Part Two of Two)," *Hedge Fund Law Report*, May 9, 2024

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