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FINANCIAL MARKETS AND FUNDS ADVISORY

SEC Deals New Proposal to Expand Reach of Dealer Registration Requirements

April 5, 2022

KEY POINTS

- New proposed SEC rules would expand who may be considered a dealer or a government securities dealer under the Securities Exchange Act of 1934.
- If the proposed new rules are adopted, a large group of currently unregistered active traders would be required to register with the SEC.
- The SEC's proposal aims to close a regulatory gap the Commission believes exists between the registration status and regulation of market participants.

The Securities and Exchange Commission (SEC) has proposed two new rules that, if adopted, would dramatically expand who may be considered a dealer or a government securities dealer under the Securities Exchange Act of 1934, as amended (the Exchange Act), and be required to register in such capacity.

If adopted, these proposed new rules would largely eliminate decades of established precedent distinguishing between "dealer" activity necessitating registration and "trader" activity that does not. In particular, under the proposed new rules, the following activities would require registration as a dealer and/or government securities dealer: (i) routinely engaging in day trading; (ii) putting out bids and offers on both sides of the market; and (iii) earning revenue "primarily" from capturing the bid-ask spread or from capturing incentives offered by trading venues to supply liquidity. In addition, the proposed new rules include a catch-all provision requiring government securities dealer registration for any firm that buys and sells more than $25 billion in government securities during a six-calendar-month period.

New registrants also would be required to become members of the Financial Industry Regulatory Authority (FINRA) or another self-regulatory organization (SRO) and comply with a host of SEC and SRO requirements applicable to broker-dealers.

Background

The Exchange Act defines the term "dealer" as "any person engaged in the business of buying and selling securities . . . for such person's own account through a broker or otherwise."[1] The Exchange Act explicitly excludes from the "dealer" definition "a person that buys or sells securities . . . for such person's own account,

[1] Section 3(a)(5)(A) of the Exchange Act.

either individually or in a fiduciary capacity, but not as a part of a regular business."[2] Similarly, the Exchange Act sets forth parallel language applicable to government securities dealers.[3]

Traditionally, whether a person is a "dealer" or a "government securities dealer" turns on two factual questions:

1. whether a person is "buying and selling securities for its own account," and
2. whether a person is engaged in that activity "as part of a regular business."

As a general matter, any person that trades securities for its own account "but not as a part of a regular business" is commonly known as a "trader." Individuals who buy and sell securities for their own investment accounts and do not carry on a public securities business generally are traders and not dealers or government securities dealers. The level of a dealer's or government securities dealer's activity in securities transactions is usually more than that of an active trader. However, regularity and level of participation in buying and selling securities or volume of transactions are often not enough to make a person a "dealer" or "government securities dealer."

Over the years, the SEC and the courts have identified some activities that are typical for dealers, but are not usually engaged in by ordinary traders, including but not limited to the following:

> (1) purchasing or selling securities as principal from or to customers; (2) carrying a dealer inventory in securities (or any portion of an affiliated broker-dealer's inventory); (3) quoting a market in or publishing quotes for securities (other than quotes on one side of the market on a quotations system generally available to non-broker-dealers, such as a retail screen broker for government securities) in connection with the purchase or sale of securities permitted under Rule 15a-1; (4) holding itself out as a dealer or market-maker or as being otherwise willing to buy or sell one or more securities on a continuous basis; (5) engaging in trading in securities for the benefit of others (including any affiliate), rather than solely for the purpose of the OTC derivatives dealer's investment, liquidity, or other permissible trading objective; (6) providing incidental investment advice with respect to securities; (7) participating in a selling group or underwriting with respect to securities; or (8) engaging in purchases or sales of securities from or to an affiliated broker-dealer except at prevailing market prices.[4]

Proposed New Rules Would Expand the Definition of "Dealer" and "Government Securities Dealer"

As set forth in greater detail below, the proposed new rules would abolish much of the dealer/trader distinction described above by significantly expanding the scope of activities deemed to be "dealer" activity and/or "government securities dealer" activity.

"As a Part of a Regular Business"

Under the Exchange Act, a person is deemed a "dealer" or "government securities dealer" if that person buys and sells securities for "its own account" and "as a part of a regular business."[5] Under the proposed new rules, the following activities — if conducted on a routine basis — would be considered "as a part of a regular business":

1. purchasing and selling the same or substantially similar securities in a day;
2. expressing trading interests at or near the best available prices on both sides of the market; or

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[2] Section 3(a)(5)(B) of the Exchange Act.

[3] Section 3(a)(44) of the Exchange Act.

[4] Definition of Terms in and Specific Exemptions for Banks, Savings Associations, and Savings Banks Under Sections 3(a)(4) and 3(a)(5) of the Securities Exchange Act of 1934, Exchange Act Release No. 47,364, 68 Fed. Reg. 8686 (Feb. 24, 2003) (quoting OTC Derivatives Dealers, Exchange Act Release No. 40,594, 63 Fed. Reg. 59362 (Nov. 3, 1998)).

[5] Sections 3(a)(5)(B) and 3(a)(44)(A) of the Exchange Act.

3. earning revenue primarily from buying at the bid and selling at the offer or from capturing any incentives offered by trading venues to liquidity-supplying trading interests.

In addition, solely with respect to government securities, the proposed new rules would require anyone with trading activity exceeding $25 billion in government securities during a six-calendar-month period to register as a government securities dealer. This catch-all provision would apply to any person exceeding the threshold regardless of the type of trading activity engaged in by the person.

Taken together, these proposed changes would effectively re-characterize active trading as "dealer" and/or "government securities dealer" activity. As such, if the proposed new rules are adopted, a broad swath of currently unregistered active traders would be required to register with the SEC.

"Own Account"

In addition to re-characterizing traditional "trader" activity as "dealer" activity as described above, the proposed new rules also expand what is meant by "own account" under the Exchange Act. More specifically, under the proposed new rules, a person's "own account" would include the following:

1. an account held in the name or for the benefit of that person;

2. an account held in the name or for the benefit of a person with whom that person is under common control, subject to certain enumerated exceptions applicable to various categories of registrants; and

3. an account held in the name or for the benefit of a person over whom that person exercises control, subject to certain enumerated exceptions applicable to various categories of registrants. Among other things, under these new rules, an investment adviser would be required to include as part of its "own account" an account for which the adviser either controls 25 percent of the voting securities of an advisee or has contributed 25 percent of the capital of an advisee.

Further, the new rules would include certain aggregation requirements between, for example, funds that engage in parallel trading strategies. The definitions also would apply to private funds. As noted in the proposing release, the SEC believes that "some private funds — particularly some hedge funds — engage in activities that have the effect of providing liquidity in securities market."

Exclusions

The definitions would exclude persons that own or control assets of less than $50 million. Likewise, the definitions would exclude persons registered with the SEC as investment companies. The SEC is proposing to exclude registered investment companies for several reasons, including that registered investment companies are subject to a regulatory framework under the Investment Company Act of 1940, as amended, and rules thereunder.

No Presumption

Separately, the proposed new rules clarify that there is no presumption that a person is not a "dealer" or "government securities dealer," as applicable, solely because that person does not satisfy the "as a part of a regular business" requirements set forth above.

Consequences of the Need to Register as a Dealer or Government Securities Dealer

A market participant that is not registered as a broker-dealer that comes within the scope of the proposed rules would need to register with the SEC and become a member of FINRA or another SRO (unless a separate exemption or exclusion from registration applies). Numerous requirements would apply to these new registrants, including filing Form BD with the SEC and completing the SRO's processes for new members. In addition, the following requirements (among others) will apply:

- Net Capital. Each dealer and government securities dealer registered with the SEC as a broker-dealer is subject to the minimum net capital and related financial responsibility requirements under SEC rules.[6] Among other requirements, a broker-dealer must maintain net capital that meets or exceeds its minimum requirement prescribed under SEC rules.[7] (Importantly, note that any dealer and/or government securities dealer may be permitted to elect to operate under (a)(6) of SEC Rule 15c3-1 and obtain more favorable capital treatment for transactions resulting from its bona fide market making activities.)[8] In addition, a broker-dealer is subject to the one-year capital withdrawal restriction that, in effect, requires a broker-dealer to treat any capital to be withdrawn within one year of its contribution as a liability.[9] A broker-dealer also is responsible for filing financial reports with the SEC on a periodic basis.[10]
- Recordkeeping. Each dealer and government securities dealer registered with the SEC as a broker-dealer is subject to the recordkeeping requirements under SEC rules.[11] Among other requirements, this will mean maintaining an extensive set of records relating to registrant's business as a broker-dealer for prescribed periods of time (generally three to six years, depending on the type of records).[12]
- Market Access. Each dealer and government securities dealer registered with the SEC as a broker-dealer with market access to an exchange or alternative trading system is subject to the market access requirements under SEC rules.[13] Among other requirements, a broker-dealer subject to the market access requirements must adopt and maintain a financial and regulatory risk management systems as specified under SEC rules.[14]
- Supervision and Qualifications of Personnel. In addition to the SEC requirements described above, each registrant must be adequately supervised by qualified personnel as specified by the rules of FINRA and/or another applicable SRO. For example, unless an exception applies, a FINRA member broker-dealer must have in place (among other requirements) a minimum of two general securities principals, a financial and operations principal, a principal financial officer, a principal operations officer and a chief compliance officer.[15] Each of these individuals must take and pass the requisite examinations as set forth in FINRA rules.[16]

Entities that already are registered as broker-dealers may have to request permission from FINRA to amend their membership agreements to permit them to engage in dealer activity. This may entail drafting new compliance procedures and increased net capital requirements.

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6 *See* SEC Rule 15c3-1.

7 *Id.*

8 *Id.*

9 *Id.*

10 *Id.*

11 *See* SEC Rules 17a-3 and 17a-4.

12 *Id.*

13 *See* SEC Rule 15c3-5.

14 *Id.*

15 *See* FINRA Rules 1210 and 1220.

16 *Id.*

The SEC is proposing to provide these market participants a one-year compliance period from the effective date of any final rules.

Potential Consequences Affecting Private Investment Funds

The proposed new rules present various considerations for investment funds and their advisers. It is unclear, for example, whether a private fund, its adviser, or both would be required to register as broker-dealers. It is likely the SEC would require the adviser to register, although the basis for this possible position is unclear. If a private investment fund is required to register with the SEC as a broker-dealer, then the investment fund would need to subject a sufficient portion of its assets to the one-year capital withdrawal restriction described above. Likewise, the investment fund would need to adapt its structure to adequately address various other supervisory, financial disclosure and tax considerations associated with broker-dealer registration. Similarly, to the extent that an investment adviser is required to register as a broker-dealer, the adviser would need to maintain adequate net capital within the adviser entity in accordance with SEC rules.

If the proposed new rules require both the private fund and its adviser to register as broker-dealers, the result would be duplicative registrations.

Potential Consequences Affecting Cryptoassets

Although cryptoasset trading platforms that typically interact with counterparties on a principal basis are nowhere referenced in the SEC's proposal, it appears possible that the SEC could claim its new rules, if adopted, apply to all platforms, both so-called centralized finance (CeFi) platforms, and automated market makers in decentralized finance (DeFi) that make markets in cryptoassets that the SEC believes are securities. It is also possible that that the SEC might regard liquidity providers to such entities as also being in scope.

The SEC's Stated Rationale

The intended effect of these expanded definitions is to require certain active market participants that currently meet the registration exclusion because the entity buys or sells securities or government securities for its own account, but not as a part of a regular business, to become registered and subject to SEC and regulatory oversight. The SEC cited studies that found that unregistered market participants accounted for the majority of trading in the electronic interdealer US Treasury market and major trading platforms.

The SEC identified what it believed to be a regulatory gap in terms of the registration status and regulation of market participants. Certain market participants that are not registered as broker-dealers because they currently fall under the exclusion, play an increasingly significant role as major liquidity providers across asset classes in the US securities markets, including the US Treasury market. According to the SEC, the distinction between these unregulated market participants and regulated dealers are, in effect, less meaningful than the importance that significant market participants providing liquidity to the markets comply with the panoply of regulatory oversight rules.

The SEC also noted that some market commentators and regulators believe that the rise of unregulated high volume market participants combined with the rise of electronic trading may be a contributing factor in more frequent market disruptions. The SEC proposes to expand the "dealer" and "government securities dealer" definitions to close the perceived regulatory gap because of the increasingly central role of these market participants as liquidity providers.

In support of the new proposal, SEC Chair Gensler stated, "I believe it reflects Congress's statutory intent that firms engaging in important liquidity-providing roles in the securities markets, including in the US Treasury

market, be registered with the Commission. Further, requiring all firms that regularly make markets, or otherwise perform important liquidity-providing roles, to register as dealers or government securities dealers also could help level the playing field among firms and enhance the resiliency of our markets."[17]

Comment Period

The proposal will be published on SEC.gov and in the Federal Register. The public comment period will remain open for 60 days following publication of the proposing release on the SEC's website or 30 days following publication of the proposing release in the Federal Register, whichever period is longer.

[17] Statement on the Further Definition of a Dealer-Trader, Chair Gary Gensler, March 28, 2022, available at https://www.sec.gov/news/press-release/2022-54

CONTACTS

For more information, please contact any of the following members of Katten's Financial Markets and Funds practices.

Lance A. Zinman
+1.312.902.5212
lance.zinman@katten.com

James M. Brady
+1.312.902.5362
james.brady@katten.com

Gary DeWaal
+1.212.940.6558
gary.dewaal@katten.com

Susan Light
+1.212.940.8599
susan.light@katten.com

Richard D. Marshall
+1.212.940.8765
richard.marshall@katten.com