SEC EXPANDS "DEALER" DEFINITION TO CAPTURE LIQUIDITY PROVIDERS

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INTRODUCTION

On 6 February 2024, the US Securities and Exchange Commission (SEC) voted 3-2 to adopt two new rules that significantly expand the definitions of a “dealer” and “government securities dealer” in Sections 3(a)(5) and 3(a)(44) of the Securities Exchange Act of 1934 (the Exchange Act). Exchange Act Rules 3a5-4 and 3a44-2 (together, the Final Rules) require certain market participants, particularly those who take on significant liquidity-providing roles in the markets, referred to as “*de facto* market makers” by the SEC, to register with the SEC under Section 15 or 15C of the Exchange Act, respectively; become members of a self-regulatory organization (SRO); and comply with federal securities laws and regulatory obligations applicable to dealers.

For a summary of the Final Rules, please see our blog post. This article is intended to provide a more detailed analysis of the Final Rules, their potential impact to market participants, and other regulatory developments for dealers. In short:

- The Final Rules significantly expand the definitions of a “dealer” and “government securities dealer” by defining the phrase “as a part of a regular business” in those definitions.
- The Final Rules establish two nonexclusive qualitative standards to determine whether market participants are providing significant liquidity.
- The Final Rules exclude persons that have or control total assets of less than US$50 million and exclude investment companies registered under the Investment Company Act of 1940, central banks, sovereign entities, and international financial institutions.
- Over 40 market participants will have to register as dealers or government securities dealers, including most proprietary and principal trading firms, some private funds, investment advisers and family offices, and crypto automated market makers.

The Final Rules were published in the *Federal Register* on 29 February 2024, are effective 29 April 2024 with a compliance date one year later on 29 April 2025.

Section 3(a)(5) of the Exchange Act defines the term “dealer” to mean “any person engaged in the business of buying and selling securities . . . for such person's own account through a broker or otherwise” but excludes “a person who buys or sells securities . . . for such person's own account, either individually or in a fiduciary capacity, but not as a part of a regular business.”[1] Similarly, Section 3(a)(44) of the Exchange Act defines the

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term “government securities dealer.” This language excluding activities that are “not as a part of a regular business” is often referred to as the “dealer/trader distinction.” Many market participants, particularly proprietary or principal trading firms, have long relied on this distinction to conclude that they are not subject to SEC registration under previous guidance that focused on activities such as market making or underwriting and not on the impact to market liquidity.

The Final Rules significantly alter this landscape by defining what it means to be engaged in the business of buying and selling securities “as a part of a regular business” as well as the phrase “own account” to address SEC concerns that certain market participants, particularly proprietary or principal trading firms, act as *de facto* market makers without registration and with limited regulatory oversight. In this regard, the SEC indicated in the Adopting Release of the Final Rules (the Adopting Release) that the Final Rules “were designed to define the types of activities that would cause a person to be regarded as a *de facto* market maker and therefore subject to registration as a dealer under sections 15 and 15C of the Exchange Act.” However, the SEC explicitly stated in the Adopting Release that the Final Rules are not the exclusive means of establishing that a person is a dealer or government securities dealer. Amendments were initially proposed on 28 March 2022 (the Proposed Rules) and were modified to address the many comment letters submitted by industry participants.

OVERVIEW OF THE FINAL RULES

Qualitative Standards

The Final Rules establish two nonexclusive qualitative standards that constitute dealer activity “as a part of a regular business.” Specifically, under the Final Rules, a person buying and selling securities, or government securities, for its own account would be deemed to engage in such activity “as a part of a regular business” if the person engages in a “regular pattern” of buying and selling securities that have the effect of providing liquidity to other market participants by:

- Regularly expressing trading interest that is at or near the best available prices on both sides of the market for the same security and that is communicated and represented in a way that makes it accessible to other market participants (the expressing trading interest standard); 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 interest (the primary revenue standard).

The expressing trading interest standard is intended to capture “the hallmark *de facto* market making activity in which dealers make a market in a security, standing ready to trade on both sides of the market on the same security on a regular ongoing basis.” In other words, market participants that provide critical sources of liquidity. The SEC declined, however, to offer any guidance on what it means to express interest “at or near the best available prices[,]” explaining that it would be a question of facts and circumstances related to a given security.

The term “primarily” in the primary revenue standard means the person derives the majority of their revenue from either of the sources described and, therefore, would likely be in a regular business of buying and selling securities or government securities for its own account.

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In the event a market participant satisfies either of the qualitative prongs of the Final Rules, they would be required to register as a "dealer" or "government securities dealer," as applicable, with the SEC and become a member of an SRO, unless they satisfy the terms of one of the exclusions included in the Final Rules.

Definition of "Own Account"

The Final Rules define "own account" to mean an account:

- Held in the name of that person; or
- Held for the benefit of that person.

As a result, the expressing trading interest standard would not capture market participants that place orders or request quotations on behalf of their clients as agents or trustees for the benefit of their underlying clients. While the SEC indicated that this (in combination with deleting the aggregation standard discussed below) was designed to limit the Final Rules' applicability to advisers and private funds, it remains to be seen whether those entities' other activities will require them to register.

Exclusions

The SEC recognized that certain market participants are already subject to extensive oversight or may be less likely to pose certain financial and operational risks to the market. In this regard, the Final Rules prescribe three exclusions for certain specific market participants. If a market participant satisfies any of the three categories below, they would not be deemed to engage in buying and selling securities, or government securities, "as a part of a regular business[,]" so long as the market participant is:

- A person that has or controls total assets of less than US$50 million (the Asset Threshold);
- An investment company registered under the Investment Company Act of 1940; or
- A central bank,[2] sovereign entity,[3] or international financial institution.[4]

Notably, an "international financial institution" refers to a specific type of entity that provides financing for national or regional development and in which the US government is a shareholder or contributing member. It does not include trading entities organized and operating outside of the United States.

Market participants satisfying one of the exclusions would not be required to register with the SEC as a dealer or government securities dealer under the Final Rules. As discussed below, in the event a market participant satisfies any previously adopted standard for "dealer" or "government securities dealer" registration, such participant would still be mandated to register as such.

Asset Threshold

Market participants who meet the qualitative standards, but who do not meet the Asset Threshold are not deemed to be engaged in buying and selling securities "as part of a regular business." Therefore, a preliminary question in determining the applicability of the Final Rules is whether a person has or controls total assets of less than US$50 million. The SEC stated that providing this exception was appropriate because even though a person that has or controls less than US$50 million might still be engaged in the qualitative activities, the frequency and nature of such a person's securities trading is less likely to pose the types of financial risks to the market associated with the significant dealer activities that the Final Rules were designed to address.

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The Asset Threshold is critical in determining whether a market participant is required to register and yet the Adopting Release devotes three paragraphs to the discussion. Neither the Final Rules nor the Adopting Release provide any clarity on how those assets should be calculated. In the Adopting Release and in footnote 215 of the Adopting Release, the SEC reasoned that the Asset Threshold is not an arbitrary standard and is parallel with Financial Industry Regulatory Authority (FINRA) Rule 4512(c)'s "established and well understood standard for distinguishing between 'retail' and 'institutional investors.'"[5] The Adopting Release also referred to a similar net worth test for institutional counterparties for security-based swap dealers, but the Asset Threshold is distinct from the SEC's "*de minimis* exemption" for security-based swap dealers, which is instead based on the aggregate gross notional value of the entity's "dealing" swaps over the course of the preceding 12-month period (and varies based on asset class).[6]

However, the Final Rules do not describe whether the US$50 million threshold is limited to securities assets traded in the account(s). The comparison to FINRA Rule 4512(c) is confusing because that definition is a net worth test that includes securities assets, as well as real estate, commodities, and other assets. The FINRA institutional investor definition is a test of financial sophistication that impacts suitability and communication obligations with respect to those customers. If the dealer threshold is in fact a net worth test, then it could lead to odd outcomes related to frequent trading with smaller amounts of funds with no conceivable impact on the markets. Another important consideration is whether the Asset Threshold includes securities traded on margin. Also unclear is how a firm whose assets hover around US$50 million should prepare given that the Asset Threshold did not include an average over any period of time.

As discussed further below, the Asset Threshold exclusion is not an exclusion from the "dealer" definition for all purposes, but only for purposes of the Final Rules that focus on *de facto* market making. Outside of this context, the question of whether any person, including a person that has or controls less than US$50 million in total assets, is acting as a dealer, as opposed to a trader, will remain a facts-and-circumstances determination. For example, an underwriter with assets below US$50 million would still be required to register as a dealer.

Anti-Evasion

Under the Final Rules, no person shall evade the new registration requirements in the Final Rules by (i) engaging in activities indirectly that would satisfy either of the qualitative prongs, or (ii) desegregating accounts. In the event a market participant indirectly satisfies either qualitative prong or purposely desegregates its accounts to avoid the registration requirements of the Final Rules, such participant will be subject to potential SEC enforcement.

No Presumption

The last provision of the Final Rules, which provides for some clarity on the expanded definition of "dealer" or "government securities dealer," is the "no presumption" provision. Market participants who do not satisfy the qualitative factors or who may meet an exclusion may still be required to register. Simply put, the Final Rules state that there is no presumption that a market participant is not a "dealer" nor a "government securities dealer" if they do not satisfy the qualitative standards outlined in the Final Rules. Existing precedent and SEC interpretations and standards continue to apply.

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KEY MODIFICATIONS FROM THE PROPOSED RULES

The Final Rules were modified to narrow the scope of the Proposed Rules in response to commenters' concerns, and those modifications offer some guidance.

Eliminated First Proposed Qualitative Standard – Pattern of Trading

The first proposed qualitative standard was intended to capture a person's pattern of trading and would have deemed market participants "[r]outinely making roughly comparable purchases and sales of the same or substantially similar securities in a day" as engaging in buying and selling securities "as a part of a regular business." Commenters raised a number of concerns with this standard, including that it was over-inclusive and would capture persons investing in the ordinary course. The SEC eliminated this proposed qualitative standard from the Final Rules.

Revised Second Proposed Qualitative Standard – Expressing Trading Interest

The second proposed qualitative standard sought to identify a person that "routinely" expresses trading interests. "Routinely" was defined to mean that "a person must express trading interests more frequently than occasionally, but not necessarily continuously, both intraday and across time."

In the Final Rules, the SEC replaced the term "routinely" with "regularly." The SEC indicated that whether a person's activity is regular will depend on the facts and circumstances, including the liquidity and depth of the relevant market for the security. Additionally, the term "regularly" aligns with the language of the existing definition and the phrase "part of a regular business." The expressing trading interest standard was also modified from the Proposed Rules to add the phrase "for the same security" to the standard. This was intended to clarify that the standard applies when a person is on both sides of the market for the same security and thus has the effect of providing liquidity.

Eliminated Quantitative Standard

The SEC proposed a quantitative standard that would have established a bright-line test under which persons engaging in certain specific levels of activity in the US Department of the Treasury (US Treasury) market would be defined to be buying and selling government securities "as a part of a regular business," regardless of whether they meet any of the qualitative standards. That standard, which applied only to government securities dealers, would have required registration for market participants who "[i]n each of four out of the last six calendar months, engaged in buying and selling more than $25 billion of trading volume in government securities as defined in Section 3(a)(42)(A) of the Exchange Act." The majority of commenters raised several issues and concerns with a standard based on trading volume, including that it would capture nondealing trading activity, such as hedging, risk-reducing activity, and arbitrage trading. The SEC eliminated this proposed quantitative standard from the Final Rules.

Narrowed Definition of "Own Account" but Added "Anti-Evasion"

In response to concerns raised by commenters regarding the application of the new dealer regime to registered investment advisers and private funds as proposed, the definition of "own account" was modified in the Final Rules by removing the aggregation standard but adding a two-prong anti-evasion provision in an effort to prohibit persons from willfully evading the registration requirements.

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The SEC had proposed to define "own account" to include accounts "held in the name of a person over whom that person exercises control or with whom that person is under common control." Commenters raised concerns that the proposed definition of "own account" would capture separately managed accounts and investment advisers trading on behalf of their clients, including those exercising discretion over unrelated client accounts. Furthermore, the proposed aggregation standard would force market participants to constantly monitor their trading activities across all subsidiaries and client accounts. The SEC acknowledged these concerns, and many others, and revised the definition of "own account" in the Final Rules to remove the aggregation concept. As a result, the SEC added an anti-evasion provision in order to "deter the establishment of multiple legal entities or accounts to evade appropriate regulation."

Added Official Sector Exclusions

In addition to excluding registered investment companies in the Proposed Rules, the Final Rules include an additional express exclusion for central banks, sovereign entities, and international financial institutions.

WHO IS AFFECTED BY THE FINAL RULES?

According to the SEC, it has identified up to 43 entities that may be affected by the Final Rules and required to register, based on data from the Trade Reporting and Compliance Engine (TRACE) and Form PF. However, the actual impact will likely be far greater, as the SEC admitted it did not have data from the all of the different potential parties, thus making the exact number difficult to estimate. Below, we discuss a number of the types of market participants expected to be required to register as "dealers" or "government securities dealers."

Proprietary or Principal Trading Firms

The SEC observed the growth of proprietary trading firms in recent years, including that such proprietary trading firms had by far the highest trading volume among nonregistered firms and that such firms' trading volume was roughly comparable to those of the most active registered dealer firms, including particularly in the interdealer segment of the US Treasury market.

Private Funds, Registered Investment Advisers, and Family Offices

The SEC did not adopt an express exclusion for private funds or registered investment advisers, noting that a private fund or investment adviser may be engaged in dealing activity for its own account. In the proposing release, the SEC indicated that private funds "are not subject to the extensive regulatory framework of the Investment Company Act." Commenters described the difficulties with applying the dealer framework to private fund advisers and private funds, noting that liquidity could be negatively affected if private funds were to modify or cease their trading activity. However, the SEC indicated that it expects that only a limited number of private funds (fewer than 16) will be affected by the Final Rules due to the revised definition of "own account." Although single-family offices generally are excluded from registration as investment advisers, they could be subject to a much more stringent dealer regulatory regime if their trading meets the qualitative standards.

Crypto Assets and Automated Market Makers

The Final Rules would apply to any crypto asset that is a "security," as defined by Section 3(a)(10) of the Exchange Act, or a "government security," as defined by Section 3(a)(42) of the Exchange Act. In response to requests from commenters for the Final Rules to not apply to crypto asset securities that are traded through

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centralized trading platforms or in the so-called decentralized finance (DeFi) market, the SEC instead clarified in the Adopting Release that "there is nothing about the technology used . . .that would preclude crypto asset securities activities from falling within the scope of dealer activity." Accordingly, regardless of the technology used to engage in crypto asset securities trading and transactions, if the market participant executing the transactions meets the definition under the Final Rules, or other precedent and interpretations, that market participant is subject to registration as a dealer.

While the Adopting Release did not shed much light on the topic, the questions posed by SEC Commissioner Hester M. Peirce and answers by SEC Trading and Markets Director Haoxiang Zhu did. Commissioner Peirce inquired how the Final Rules would apply to DeFi automated market makers, explaining that they are essentially software protocols that establish smart contracts enabling users to provide pools of liquidity. Mr. Zhu stated that, as with respect to other market participants, whether a DeFi protocol or its governing body is required to register as a dealer would be determined on a facts-and-circumstances basis, and he also noted that the market participants posting liquidity in pools could also be captured by the Final Rules if they meet the conditions. Mr. Zhu also stated that the developers that wrote the code would not be required to register unless they also used the software to engage in activity meeting the definition of "dealer" or "government securities dealer." Commissioner Peirce also questioned if, given the difficulties that other prospective crypto registrants have encountered, the automated market makers would even be able to register.

Pension Funds

While the Final Rules do not define the term "pension fund" or exclude pension funds, the Adopting Release indicates that the Final Rules are not expected to capture a governmental plan, including public pensions, nor state administrators managing state funds or city administrators managing the city pension funds. In most cases, those entities would not likely be expected to meet the expressing trading interest standard or the primary revenue standard.

IMPACT ON AFFECTED PARTIES – IMPOSING DEALER REQUIREMENTS

SEC Registration and SRO Membership – Regulatory Oversight and Examination

Affected parties must register as dealers or government securities dealers with the SEC under Section 15 or Section 15C, respectively, and become a member of an SRO (FINRA being the only current option). FINRA member firms operate under a FINRA membership agreement and must conduct their business consistent with the membership agreement. Dealers and government securities dealers are subject to SEC and FINRA rules. The Exchange Act subjects such parties to inspections and examinations by the SEC staff and FINRA.

Exchange Act Rule 15b2-2 generally requires the examining SRO to inspect newly registered dealers for compliance with applicable financial responsibility rules (discussed below) within six months of registration and for compliance with all other regulatory requirements within 12 months of registration. Thereafter, examinations are periodic. SEC-registered dealers must also become members of the Securities Investor Protection Corporation (SIPC). Government securities dealers are not required to be members of SIPC.

Net Capital Requirements

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Dealers and government securities dealers are subject to certain financial responsibility and risk management rules under SEC and FINRA rules. Specifically, Rule 15c3-1 under the Exchange Act (Net Capital Rule) requires registered dealers to maintain minimum amounts of net liquid assets at all times, calculated on a moment-to-moment basis. Dealers are required to hold at all times more than one dollar of highly liquid assets for each dollar of unsubordinated liabilities (e.g., money owed to customers, counterparties, and creditors). Government securities dealers are required to comply with capital requirements in 17 C.F.R. § 402.2 rather than with the Net Capital Rule. The requirements generally serve the same risk-limiting purpose as the Net Capital Rule. It is unclear how these net capital requirements will implicate the non-dealer-related activities of a private fund.

Recordkeeping and Reporting Requirements

Dealers and government securities dealers registered with SEC must comply with federal securities laws and regulatory obligations and applicable SRO membership and US Treasury rules and regulations, including transaction and other reporting requirements, operational integrity rules, and books and records requirements. For example, dealers have reporting obligations to Consolidated Audit Trail (CAT), if they transact in CAT-reportable securities, and TRACE, if they transact in TRACE-eligible securities. There are also various recordkeeping requirements under the Exchange Act, SRO rules, and, in some instances, state regulatory requirements.

FINRA Rules

FINRA imposes other rules on its members, including registration and qualification of personnel and supervisory and conduct rules. Many of these rules were designed to provide protection to customers. Previously, the proprietary trading firms were seen as customers themselves, benefitting from those rules when they traded through brokerage accounts.

For example, a dealer registered with the SEC and a member of FINRA is subject to Rule 5130, which prohibits member firms from selling new issues (e.g., initial public offerings (IPOs)) to restricted persons. Generally, a dealer, along with the owners that would be listed on Form BD (e.g., 5% direct owners, 25% indirect owners) would be considered “restricted persons” and subject to the new issue restrictions. FINRA member firms are also prohibited from purchasing new issue securities. Accordingly, hedge funds that buy IPO shares and also engage in trading activities now requiring dealer registration would no longer be permitted to invest in IPOs, forcing them to choose between one or the other activity.

FINRA members also have a duty of best execution under FINRA Rule 5310, which may conflict with a private fund adviser's fiduciary duty to achieve best execution for its client, the fund.

Compliance Costs

In addition to the compliance implementation costs, affected parties will incur ongoing annual costs to maintain FINRA membership, including, among others, the gross income assessment, trading activity fee, and registration fees. Furthermore, FINRA member firms are required to file an application with, and receive approval from, FINRA if the firm anticipates a material change in its business operations, which would create additional expenses and regulatory requirements. SEC-registered dealers are also subject to state licensing and registration requirements, including paying annual fees for the firms and personnel.

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DISSENTS

The Final Rules were accompanied by sharp dissents from SEC Commissioner Peirce and Commissioner Mark T. Uyeda. Commissioner Peirce expressed concerns that the Final Rules "will distort market behavior and degrade market quality" by turning traders, previously considered customers, into dealers and "obliterating" the dealer/trader distinction. Commissioner Peirce cited to long-standing SEC guidance describing the relevant factors to determine dealer status, which include intentional activities, such as having regular clientele, holding themselves out as buying or selling securities at a regular place of business, having a regular turnover of inventory, and generally providing liquidity services in transactions with other professionals, rather than focusing on the singular and ultimate effect of providing liquidity.

Commissioner Peirce further described potentially "absurd" results for market participants who currently do not have the characteristics of dealers but who as a result of "executing any of a number of common trading, investing, and risk management strategies could turn a market participant into a dealer if doing so happens to provide significant liquidity to the market" and subject them to the dealer regulatory regime, stripping them of the protections they now have as customers. She predicted that the costs of complying with the regulatory regime penalizes important liquidity providers and will cause many to cease activities, which could cause harm to the markets in times of volatility. She rejected contentions that the Final Rules will provide more data to regulators, pointing to existing market surveillance tools, such as CAT, TRACE, and Form PF. Further, she raised serious implementation challenges, including ambiguity, which may lead to registration of firms not intended to be included, a too-short implementation period, and unpredictable interactions with other rules.

Commissioner Peirce also asked a number of questions to the SEC staff, requesting more information on why private funds and pension funds were not excluded from the Final Rules given their similarities to registered investment companies and the potential impact of the Final Rules on automated market makers, to name a few. Commissioner Uyeda shared many of Commissioner Peirce's sentiments, stating that, under the Final Rules, the SEC's amendment to the definition of "dealer" extends beyond its statutory authority and the "lack of any limiting principle" creates the potential for "arbitrary and capricious government action." He cautioned that the action may have the effect of reducing liquidity in the US Treasury markets, making them more volatile and increasing debt costs to taxpayers. He commented that the Final Rules target proprietary trading firms and private funds and "following Form PF, the adoption of private fund adviser rules, securities lending disclosure, and short position and short activity reporting, this action feels like another salvo in the Commission's war on private funds." He argued that it "makes no sense to use liquidity provision as the basis for legally distinguishing between dealers and traders."

Commissioner Uyeda described the important role that proprietary trading firms and private funds played in providing liquidity, competition, and tighter spreads in the public debt markets in times of market stress at the same time that banks faced limitations resulting from the supplemental leverage ratio. He argued that there are already tools available to constrain and monitor proprietary trading firm risk. When trading through other broker-dealers as customers, proprietary trading firms are subject to margin limitations of Federal Reserve Regulations T, U, and X, as well as FINRA Rule 4210. If they trade directly through broker-dealer-provided direct market access, they are subject to Rule 15c3-3, the "Market Access Rule."

Commissioner Uyeda stated that the Net Capital Rule is designed to protect customers during a wind-down but is not appropriate for firms that do not have customers. Further, he made interesting observations rejecting

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assertions in the Adopting Release that a dealer can have no customers, arguing that historically the definition recognized that dealers did have customers. He referred to earlier definitions of “broker” and “dealer,” referring to how they effect customer transactions. Those definitions described that while brokers, acting as agents, trade for the account of the customer, a dealer takes the opposite side of a customer's trades in the dealer's own account. Commissioner Uyeda criticized the SEC's “regulation by enforcement” in redefining brokers and dealers as they relate to customer orders and cited the recent enforcement matters referred to below. Ultimately, both Commissioner Peirce and Commissioner Uyeda voted against adopting the Final Rules and expressed their continued concerns over the potential possibility of negative impacts on market participants and the markets. The Final Rules were supported by Chair Gary Gensler, Commissioner Caroline A. Crenshaw, and Commissioner Jaime Lizárraga.

COMPLIANCE DATE

The compliance date for the Final Rules is 29 April 2025. However, the compliance date only applies to market participants who are already engaged in activities covered by the Final Rules prior to the compliance date. FINRA provides for a 180-day review period for a new member application, so in order to obtain compliance with the Final Rules, impacted firms should complete their analysis of the Final Rules in time to submit an application and obtain FINRA approval prior to the compliance date. FINRA has expressed a commitment to expedite the application process for market participants captured by the Final Rules.

OTHER REGULATORY DEVELOPMENTS FOR DEALERS

Recently, the SEC has taken two other significant steps in connection with dealer status to bring proprietary trading firms under its jurisdiction and the jurisdiction of FINRA.

Amendments to Exchange Act Rule 15b9-1

On 23 August 2023, the SEC adopted amendments to Exchange Act Rule 15b9-1 that narrowed the exemption from FINRA membership for certain SEC-registered dealers (the Rule 15b9-1 Amendments). Previously, certain proprietary trading firms could register with the SEC and become members of exchanges, one of which would act as its designated examining authority. Those firms were not required to become a member of FINRA if the firm was (i) a member of a national securities exchange, (ii) carried no customer accounts, and (iii) had annual gross income derived from purchases and sales of securities otherwise than on a national securities exchange of which it is a member in an amount no greater than US$1,000 (the *de minimis* allowance). Furthermore, the *de minimis* allowance did not apply to income derived from transactions for a registered dealer's own account with or through another registered broker or dealer (known as the proprietary trading exclusion). The Rule 15b9-1 Amendments essentially did away with the *de minimis* allowance, requiring proprietary trading firms who trade through other brokers or dealers and on alternative trading systems to become FINRA members.

Under the Rule 15b9-1 Amendments, a dealer is now required to become a FINRA member if the dealer effects transactions other than on an exchange of which it is a member, unless: (i) such transactions result solely from orders that are routed by a national securities exchange of which the firm is a member to comply with Rule 611 of Regulation NMS or the Options Order Protection and Locked/Crossed Market Plan, or (ii) are solely for the

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purpose of executing the stock leg of a stock-option order. The Rule 15b9-1 Amendments became effective on 6 November 2023, and the SEC has announced a compliance date of 6 September 2024.

FINRA has adopted a short-form membership application process for those SEC-registered dealers who are now required to become members. Firms are eligible for the short-form membership application process if they have been a member of a national securities exchange with which FINRA has had a regulatory services agreement for the 12-month period prior to 23 August 2023 and are not seeking an expansion of their activities. Absent a membership agreement, it is not always clear what activities and products are covered. Firms applying for membership under the streamlined process must submit their short-form application by 9 May 2024 (although FINRA has requested earlier submission by 8 March 2024). FINRA has publishedRegulatory Notice 23-19 to explain these changes.

While the short-form application is straightforward enough, impacted firms have a heavy lift to identify and come into compliance with FINRA rules. Previously, those firms were subject to SEC rules (such as net capital, recordkeeping, and filing Form BDs, U4s, and U5s) and the rules of the exchanges in which they were members. However, now those firms also must comply with FINRA rules where there is some, but not complete, overlap. In fact, there are many FINRA-specific rules, including personnel registration, transaction reporting, and FINRA fees and assessments, to which these impacted firms were not previously subject. The compliance gap analysis is labor-intensive, and firms will be pressed to meet the compliance deadline, which formally is 6 September but actually is triggered when the firm becomes a FINRA member.

SEC Enforcement Against Unregistered Dealers

In recent years, the SEC has aggressively pursued enforcement actions against microcap convertible lenders under the theory that their investment activity renders them “dealers” within the meaning of Section 15(b). Historically, those firms had relied on the traders exemption.
The first case, and the case on which the SEC relies in subsequent cases in the dealer enforcement strategy, was *SEC v. Big Apple Consulting USA, Inc*.[7] On 9 April 2015, the Eleventh Circuit Court of Appeals affirmed the 2013 lower court decision of the US District Court for the Middle District of Florida, which determined that the defendants violated Section 15(a) by acting as an unregistered dealer.

The appellate court relied on an analysis centered on whether the defendants operated a “business” for “profit or gain.” The evidence that Big Apple Consulting USA, Inc. (Big Apple) and MJMM Consulting LLC's (MJMM) entire business model depended on the purchasing of stocks at deep discounts and then selling those stocks for profit, and the high priority the defendants placed on generating a profit from these trades, convinced the court that Big Apple and MJMM had acted as dealers.

The appellate court's analysis in *Big Apple Consulting USA* has influenced and framed multiple litigated, settled, and pending cases, and we continue to see more enforcement activity.[8] Those cases bear close scrutiny by investors who have previously relied on the traders exemption.

CONCLUSION

In conclusion, while the impact of the Final Rules is uncertain on the effect on liquidity in the markets, we can expect significant changes to the markets. Given the short implementation period, market participants should

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begin their assessment promptly. Our experienced team stands ready to assist in performing the analysis and the FINRA new member application process.

FOOTNOTES

[1] Compare to the definition of "broker" in Section 3(a)(4) as "any person engaged in the business of effecting transactions in securities for the account of others."

[2] For the purposes of the Final Rules, "central bank" means a reserve bank or monetary authority of a central government (including the Board of Governors of the Federal Reserve System or any of the Federal Reserve Banks) and the Bank for International Settlements.

[3] For the purposes of the Final Rules, "sovereign entity" means a central government (including the U.S. Government), or an agency, department, or ministry of a central government.

[4] The Final Rules define "International Financial Institution" as one of a number of named international development banks and funds, such as "the African Development Bank; African Development Fund…and any other entity that provides financing for national or regional development in which the U.S. Government is a shareholder or contributing member."

[5] FINRA Rule 4512(c)(3) defines an "institutional account" as a "person (whether a natural person, corporation, partnership, trust or otherwise) with total assets of at least $50 million." The rule also includes banks, savings and loans, insurance companies, registered investment companies, and registered investment advisers.

[6] *Compare* 17 C.F.R. § 240.15Fh-3(f)(4), *with* 17 C.F.R. § 240.3a71-2.

[7] 783 F.3d 786 (2015); *See also* SEC v. Big Apple Consulting USA, Inc., Fed. Sec. L. Rep. P 97, 368 (2013).

[8] See *SEC v. Almagarby* (recently affirmed in part and reversed in part by the Eleventh Circuit); *SEC v. Crown Bridge Partners*; *SEC v. Fierro*; *SEC v. GPL Ventures LLC*; *SEC v. Keener d/b/a JMJ Financial*; *SEC v. LG Capital Funding LLC*; *SEC v. Morningview Financial*, *LLC*; *SEC v. River North Equity LLC*.; and, most recently, *SEC v. Aryeh Goldstein*.

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