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Client Alert

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Securities Enforcement and Regulation

FEBRUARY 09, 2024

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SEC Adopts Rules Requiring Certain Trading Entities, Including Certain Investment Advisers and Private Funds, to Register as Broker-Dealers

1. Introduction

Section 3(a)(5) of the Securities Exchange Act of 1934, as amended (the "Securities Exchange Act") defines a "dealer" as "any person engaged in the business of buying and selling securities […] for such person's own account through a broker or otherwise". Section 3(a)(5), however, specifically excludes "[…] a person that 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**". (Emphasis added.)[1]

In March 2022, the U.S. Securities and Exchange Commission ("SEC") proposed two Rules, Rule 3a5-4 and 3a44-2 (collectively, the "Rules") to further define the phrase "as part of a regular business" as that phrase is used in the Securities Exchange Act definitions of "dealer" and "government securities dealer".[2] The basic purpose behind the proposed rules is to require the registration of entities that are in the business of buying and selling securities in a manner that the SEC believes is "similar to those traditionally performed by either 'dealers' or 'government securities dealers' as defined under the [Securities Exchange Act], and despite their significant share of market volume—are not registered with the [SEC] as dealers or government securities dealers […]".[3]

On February 6, 2024, the SEC adopted the Rules. While the Rules as adopted are significantly streamlined from the Proposing Release, the core of the Rules remains: the Rules create a series of qualitative tests[4] that will require dealer registration for certain (currently) unregistered trading entities, which could include family offices; registered investment

advisers; and private funds, including those that trade algorithmically. Certain entities, such as registered investment companies, central banks (and other sovereign entities), and "international financial institutions" are exempt from dealer registration under the Rules.[5] Also exempt is any person that has or controls total assets of less than $50 million.[6]

The Rules will become effective 60 days following the publication of the Adopting Release in the Federal Register. Firms that, by operation of the Rules, must register as dealers with the SEC, must do so within one year of the effective date of the Rules.

The remainder of this note summarizes these new Rules.

2. Summary of the Rules

a. "As part of a regular business"

The Rules state that a person (or company)[7] that is engaged in buying and selling securities for its own account[8] is engaged in such activity "as part of a regular business" if that person:

"Engages in a regular pattern of buying and selling securities that has the effect of providing liquidity to other market participants by:

(1) 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; or

(2) 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";[9]

b. Conditions for designation as a Residential Supervisory Location

Under the Rules, the following entities are exempt from the revised definition of "as part of a regular business", even if they engage in the trigger activities that are enumerated in the Rules:

- Registered investment companies;
- Central banks (and other sovereign entities);
- "International financial institutions"; and,
- Any person that has or controls total assets of less than $50 million.

Notably absent from the list of excluded entities are (a) registered investment advisers,[10] (b) family offices, and (c) private funds. Also, we note that non-U.S. entities that trade with U.S.-registered broker-dealers and/or banks, or with U.S.-resident fiduciaries acting on behalf of offshore accounts, are **not** exempted from the Rules.[11]

c. Anti-avoidance provision

Under the Rules, a person may not "evade the registration requirements of [the Rules]" by either (a) engaging in activities indirectly that would give rise to the trigger activities, or (b) disaggregating accounts.[12]

3. Conclusion: Dealer or Trader? The Rules Modify a Fundamental Definitional Category.

Traditionally, the Commission and its Staff has interpreted the phrase "not as part of a regular business" to differentiate between **traders** and **dealers**. In multiple instances, the Commission and its Staff has noted the distinction between a "trader", who trades securities for his own account, on a speculative view, and who profits from market movements that are consistent with such view, and a dealer, who acts as a market intermediary and seeks to make a commission or mark-up in a manner that is agnostic to the market movement of the underlying instrument.[13]

The Commission differentiates between dealers and traders because these are, at their core, different marketplace functions, rooted in different interests. "Traders" are people who profit from the success of a trading strategy, while "dealers" derive compensation from the function of effecting transactions. In this regard, the Commission has repeatedly described the dealer's interest as a "salesman's stake", and noted that dealer registration, and its many burdens, exist to protect investors from those who profit solely from the **occurrence** of a transaction, without regard to the success or failure of the underlying investment.[14]

Historically, dealer regulation has been designed to regulate the dealer's incentives, including investor protections relating to, among other things: the maintenance of a supervisory control structure by each dealer; individual licensing of broker-dealer representatives and principals; detailed recordkeeping requirements; detailed rules regarding the extension of margin by dealers; detailed transparency rules, including trade reporting and transmission of trade confirmations; regulatory capital requirements; and segregation, possession, and control requirements relating to broker-dealers that hold customer funds and securities. The Rules will now apply this complex web of regulation to entities that were not previously within this definitional category, and which have not previously been subject to the costs of dealer status—especially including the required maintenance of net regulatory capital. The consequences of application of dealer registration and its corresponding rule set to those who have been (until now) outside the definitional category are unknown.[15]

Non-broker-dealer entities with large trading volumes, or with trading strategies that may include the trigger activities, including algorithmic and high-frequency traders, must now consider the applicability of the Rules—and the potential for dealer status and dealer registration.

[1] *See* the Securities Exchange Act, 15 U.S. Code §78c, Section 3(a)(5). Section 3(a)(44) of the Securities Exchange Act defines "Government Securities Dealer" in a materially similar way.
[2] *See "Further Definition of 'As a Part of a Regular Business' in the Definition of Dealer and Government Securities Dealer"*, SEC Release No. 34-94524 (Mar. 28, 2022), 87 FR 23054 (Apr. 18, 2022) ("Proposing Release").
[3] *See "Further Definition of 'As a Part of a Regular Business' in the Definition of Dealer and Government Securities Dealer in Connection with Certain Liquidity Providers",* SEC Release No. 34-99477, (February 6, 2024) ("Adopting Release") at Section I.
[4] The Proposing Release also proposed a series of quantitative tests that would apply a bright-line test under which persons engaging in certain specified levels of activity in the U.S. Treasury market would be defined to be buying and selling government securities "as part of a regular business" regardless of the inapplicability of the qualitative standards. After consideration of the comments, the SEC decided to eliminate the quantitative standard from the Rules. *See* Adopting Release at I.A.2.
[5] *See* Rule 3a5-4(a)(2). An "international financial institution" is defined to include "super-sovereign" entities such as the International Finance Corporation, the International Monetary 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. See Rule 3a5-4(b)(4). For convenience, this note cites only to Rule 3a5-4, which applies to "dealers". Rule 3a44-2 is substantially identical but applies to "government securities dealers".
[6] *See* Rule 3a5-4(a)(2)(i).
[7] "Person" is defined for purposes of Rule 3a5-4 by cross-reference to Section 3(a)(9) of the Securities Exchange Act, which defines a person as "a natural person, company, government, or political subdivision, agency, or instrumentality of a government". *See* Rule 3a5-4(b)(1).
[8] Under the Rules, a person's "own account" "means any account: (i) held in the name of that person; or (ii) held for the benefit of that person". *See* Rule 3a5-4(b)(2).
[9] *See* Rule 3a5-4(a)(1). We refer to Rule 3a5-4(a)(1)(i) and (ii) as the "trigger activities".
[10] Commenters to the proposed rules suggested that registered investment advisers should be exempt by virtue of their comprehensive regulatory scheme. Specifically, the Investment Advisers Act of 1940, as amended (the "Investment Advisers Act") imposes a comprehensive regulatory regime, which includes requirements regarding custody of assets, recordkeeping, transactions with affiliates and other conflicts of interest, and, critically, imposes a fiduciary duty on the investment adviser, among other things. In their trading activity, registered investment advisers, like broker-dealers, must achieve best execution on behalf of their clients and are subject to antifraud rules. Like broker-dealers, registered investment advisers must adopt, implement, and review at least annually written policies and procedures, including a code of ethics, reasonably designed to prevent violations of the Investment Advisers Act and other federal securities laws. Registered investment advisers to private funds also must periodically report to the Commission on Form PF, which provides a high level of transparency regarding many aspects of the investment operations, portfolio holdings, risk metrics and counterparty exposures, among other things, of the private funds they advise. In particular, large private fund advisers must file Form PF quarterly with the Commission. As a result, the Commission has extensive oversight of registered investment advisers and broad insight into their operations and activities.
[11] Both Regulation S under the Securities Act of 1933, as amended, and SEC Rule 15a-6, as interpreted by Staff, permit dealing with U.S.-registered broker-dealers and with U.S.-resident fiduciaries by non-U.S. entities without such entities being subject to, for example, U.S.-registered broker-dealer registration.
[12] *See* Rule 3a5-4(c).
[13] For example, in a seminal 1987 "no action" letter, SEC Staff outlined 10 factors that differentiate a trader from a dealer:
(1) issuance or origination of securities that would qualify as government securities under the Exchange Act, as amended;
(2) participation in a selling group or underwriting government securities;
(3) purchasing or selling government securities as principal from or to customers;
(4) carrying a dealer inventory;
(5) quotation of a market in government securities or publication of any quotes;
(6) advertising or otherwise holding itself out as a government securities dealer, such as holding itself out as being willing to buy and sell particular government securities on a continuous basis;
(7) rendering any incidental investment advice;
(8) extending or arranging for the extension of credit to others in connection with government securities;
(9) running a book of repurchase and reverse repurchase agreements on government securities;
(10) using an interdealer broker to effect any government securities transactions.
See SEC Staff "no action" letter regarding the Continental Grain Company (Oct. 28, 1987).
[14] *See, e.g.*, SEC Staff letter to G. Nelson Mackey, Jr., Brumberg, Mackey & Wall, P.L.C. (May 17, 2010).
[15] One factor complicating the assessment of consequences of the Rules is that the term "dealer" is used in numerous places throughout the securities laws. For example, the Rules would appear to preclude affected persons from reliance on Section 4(a)(1) under the Securities Act of 1933, as amended, and would correspondingly appear to apply Section (4)(a)(3) of that same act to the trading of such persons.