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SEC proposes requiring many private funds and proprietary trading vehicles to register as “dealers”

April 4, 2022 | Client Update | 8-minute read

The SEC has proposed expanding what constitutes a “dealer,” which could have the effect of requiring many private funds and principal trading firms to register with the SEC.

On March 28, 2022, the SEC proposed rules that would reinterpret the “dealer-trader” distinction in a way that would significantly expand the scope of market participants required to register as broker-dealers and government securities dealers. Explicitly aimed at actively trading private funds and “principal trading firms,” the proposal would vastly increase the scope of trading activities that could subject firms to dealer registration. The SEC says that the proposal is a response to the growing role that electronic trading firms play in providing liquidity to the market.

Background

The 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.” To exclude ordinary traders, a person is not a “dealer” if it does so “for such person’s own account, either individually or in a fiduciary capacity, but not as a part of a regular business.”[1] A person or entity that falls within the definition of “dealer” must register as a broker-dealer with the SEC and become a member of an SRO (typically FINRA) and comply with a comprehensive regulatory regime covering all aspects of their activities. These include financial responsibility and capital regulation, SRO restrictions on marketing (including limitations on use of performance or targets), individual personnel licensing, ongoing regulatory reporting, recordkeeping, supervisory structure requirements, and regular regulatory examinations and inspections. A similar regime exists for registration and regulation of government securities dealers, although certain banking entities that are government securities dealers must notify a bank regulator, rather than register with the SEC.

This “dealer-trader” distinction has been refined over decades based on, among others, court decisions and SEC no-action letters. In its current form, the blurry line between dealer and trader distinguishes between traders, investors and investment firms that engage in trading as a business, on the one hand, and dealers who engage in trading for the purpose of providing liquidity to the market, on the other. Among other factors, typically a firm is more likely to be viewed as a dealer if it holds itself out to the market as providing liquidity, posts two-sided quotes, buys and sells the same securities contemporaneously, and seeks to profit from bid-ask spreads rather than changes in market values.

In recent years, many electronic trading firms have used new technologies to engage in high-frequency trading—engaging in frequent purchases and sales and usually seeking to profit from temporary market discrepancies or very short-term trading opportunities. These firms typically view themselves as traders rather than liquidity-providing dealers. This could change under the proposal.

Proposal

The SEC’s proposal would look to whether a person has the *effect* of providing liquidity to the market, rather than necessarily the *purpose* of doing so. The following trading activities would be deemed to have the *effect* of providing

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liquidity to the market, and thus dealing, regardless of a firm's investment purposes:

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

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; or

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 interest.

Notably, the SEC indicates that it generally views "roughly comparable" as a "daily buy-sell imbalance" of less than 20%, effectively requiring firms to maintain material overnight exposure in order to avoid being deemed to be engaged in dealing. In addition, the SEC indicates that it could view many different securities as "substantially similar," such as those that would both reflect the performance of the same issuer, or track similar economic factors or sectors, if the "sale or purchase of one security offsets the risk associated with the sale or purchase of the other, permitting that person to maintain a near market-neutral position." Many common arbitrage trading strategies may thus be captured—including trading in ETFs and their underlying components, or related options and their underlyings.

In addition to the qualitative tests, the SEC also proposes to include a bright-line quantitative test for government securities dealing. Under the proposal, any person that engages in trading volume of more than $25 billion in government securities in each of four out of the prior six calendar months would be deemed to be a government securities dealer, regardless of any other factors.

The SEC makes clear in the proposed rules that the factors above are "not the exclusive means of establishing that a person is a dealer or government securities dealer." Determining whether a person is acting as a dealer is dependent on the facts and circumstances, and existing SEC interpretations and precedent will continue to apply.

Scope

The proposed rules would exempt anyone that controls less than $50 million in total assets (not total equity) or is registered with the SEC as an investment company under the Investment Company Act of 1940. Although registered companies are exempt, private funds could qualify as dealers under the proposed rules.

The SEC notes, however, that the proposed rules would not exclude investment advisers registered under the Investment Advisers Act of 1940 and that the dealer registration obligation could be triggered, for example, where the investment adviser is trading for its own proprietary account, or otherwise must aggregate its trading or the trading of its clients.

Aggregation

Unlike traditional dealer analysis that focuses on each legal entity, the proposal would require that firms consider their activities and, in the case of government securities, their government securities trading thresholds, aggregating across other entities that they control or are commonly controlled with (control generally being assumed at a 25% ownership threshold). Trading activities engaged in by registered broker-dealers, government securities dealers, and registered investment companies would be excluded from aggregation. However, even though not individually required to register, the activities and trading of entities with less than $50 million in total assets would be subject to aggregation with their affiliates, potentially requiring those affiliates with $50 million or more in assets to register.

While investment advisers would not generally need to aggregate the assets of their advised clients if they do not have control over the account, and their clients would not generally need to aggregate with one another, investment advisers would need to aggregate where their clients (including funds) follow a "parallel" structure, in that they follow generally the same trading strategy and invest side-by-side. The proposed rules would also generally not attribute to a registered investment adviser an account held in the name of its client, unless the adviser "controls" the client, such as through an ownership interest in the client or "the right to vote or direct the vote of voting securities" of the client. Although not entirely clear, it is possible that in some cases this could cause the general partner of a private fund to be required to aggregate with the activities of the fund. While the proposal does not specifically address family offices, because they are not registered investment advisers, it would appear that they would be required to aggregate any trading activities that they control, and could become subject to dealer registration.

Market impact and open questions

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The proposed rules are broad and, if adopted as proposed, could have a significant and unpredictable impact on the market. Many common investment strategies, such as arbitrage trading, could be viewed as falling within the qualitative dealer test. It is unclear whether firms engaging in activities that would become subject to dealer registration would choose to register or alter trading activities to avoid registration. If they choose to cease engaging in such trading, market liquidity could be impacted and arbitrage mechanisms that keep prices aligned, if not replaced by registered dealers, could fail, leading to market distortions.

The qualitative test for government securities applies regardless of the purpose of trading. Many large banks, insurance companies and other corporate entities may trade $25 billion of government securities during a month, on an aggregated basis, for their own treasury, hedging, or other investment purposes.

The proposal also presents many practical questions for firms that seek to register. The regulatory structure applicable to broker-dealers is not conducive to investment funds. For example, investment funds themselves, not just their advisers, could be subject to dealer registration, but these funds tend to be simply pools of assets, with no personnel. But many aspects of existing broker-dealer regulation require particular personnel and place obligations on those individuals. If investment funds were to register, the SEC and FINRA would need to consider how to apply these broker-dealer regulatory requirements to pools of assets with no personnel, or effectively require that traditional fund structures change to meet a newly applicable regulatory regime.

Further, while the SEC proposes to include a one-year compliance period during which firms already engaged in captured activities would have time to register, the rules themselves do not have a compliance period. As a result, after the effective date, a firm that engages in trading that could trigger the registration requirement would be required to register in advance of that activity. Although this may be manageable for the qualitative tests, firms would need systems to ensure that, on an aggregated basis, they do not exceed the $25 billion threshold for government securities trading unless already registered.

Law clerk Lucas Siegmund contributed to this update.

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If you have any questions regarding the matters covered in this publication, please reach out to any of the lawyers listed below or your usual Davis Polk contact.

Michael S. Hong
+1 212 450 4048
michael.hong@davispolk.com

Leor Landa
+1 212 450 6160
leor.landa@davispolk.com

Gabriel D. Rosenberg
+1 212 450 4537
gabriel.rosenberg@davispolk.com

Gregory S. Rowland
+1 212 450 4930
gregory.rowland@davispolk.com

Zachary J. Zweihorn
+1 202 962 7136
zachary.zweihorn@davispolk.com

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[1] Exchange Act § 3(a)(5)(b).

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