

Let's make a dealer: Active trading firms risk being considered "dealers" under new SEC rules

February 12, 2024 | Client Update | 7-minute read

While scaled back from the original proposal, the final rules expand the scope of firms required to register as dealers as a result of engaging in trading activity that has "the effect" of providing liquidity to the market.

On February 6, 2024, the SEC adopted by a 3-2 vote a set of [final rules](#) that "further define" terms used in the statutory definition of "dealer," adjusting the "dealer-trader" distinction in a way that could significantly expand the scope of market participants required to register. Separate rules address "dealer" and "government securities dealer" status, but the statutory terms and final rules are identical other than the addition of the words "government securities." For simplicity, we refer only to "dealer" unless specifically relevant.

The final rules are explicitly aimed at principal trading firms and private funds that the SEC views as acting as "*de facto* market-makers." While the SEC abandoned some of the most controversial (and likely unworkable) aspects of the [initial proposal](#), the final rules remain subject to significant ambiguities that could capture active trading firms that do not currently view themselves as engaged in dealing.

Background

Under the Exchange Act, a dealer is defined 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 investors and traders from being considered dealers, the statutory definition excludes a person that buys or sells securities not "as a part of a regular business." This somewhat circular definition and exclusion—including a person who is in the business of buying and selling, unless their buying and selling is not part of a regular business—became known as the "dealer-trader" distinction, refined over decades through court decisions and SEC no-action letters and other guidance.

As historically interpreted, a dealer such as a market maker quotes a two-sided market seeking to earn a profit on the spread, while a trader seeks to profit from market movements, even short-term ones, but would not be offering to buy and sell the same security simultaneously. As markets and trading technologies have become faster, firms seeking to profit from temporary market discrepancies or very short-term trading opportunities could be buying and selling in such rapid succession that their activities could look similar to market makers. Still, if they were trading based on *their own* investment strategies rather than seeking to profit from providing liquidity to facilitate *others'* trading, they may not have been viewed as dealers.

A person 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 its activities, including being subject to extensive financial responsibility and regulatory capital requirements.

Final rules

The final rules expand the scope of dealers by “further defining” the words “as a part of a regular business” for purposes of the trader exclusion. Under the rules, a person is a dealer, not a trader, if the person engages in a “regular pattern” of transactions that have “the effect” of providing liquidity to other market participants as a result of either:

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 (the Trading Interest Factor); 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 (the Primary Revenue Factor).

With respect to the Trading Interest Factor, the SEC believes an expression of trading interest could be “regular” even if not expressed on a continuous basis, depending on the liquidity and depth of the relevant market for the security. Importantly, the SEC indicated that a person could be considered to be expressing trading interest on “both sides of the market,” even if those interests are not expressed simultaneously—if they are “sufficiently close in time” based on the facts and circumstances in the relevant market.

With respect to the Primary Revenue Factor, while the SEC declined to adopt a bright-line test for when revenue is “primarily” earned from the relevant sources, it clarified that a person is unlikely to be “primarily” earning revenue from those sources if the majority of its revenue derives from other sources, including from appreciation of the value of its securities holdings.

Even if either factor is met, the final rules expressly exclude (1) any person that has or controls total assets of less than \$50 million, (2) registered investment companies and (3) central banks, sovereign entities and certain international development banks. Notably, these factors and exclusions are non-exclusive. Even if a firm does not satisfy either of the factors, it may nevertheless be required to register as a dealer under existing law and precedents. Similarly, if required to register under existing law and precedents, the exclusions are of no avail. For example, a firm with less than \$50 million in assets that explicitly engages in market making would likely be subject to dealer registration.

Registered investment advisers are not excluded from the scope of the final rules.

The compliance date will be one year from the effective date of the final rules, which will be 60 days after their publication in the Federal Register.

Key modifications to the proposed rules

In response to commenters, the SEC dropped some of the most expansive aspects of the proposed rules, discussed in our previous [client update](#) on the topic. Of particular note, the SEC declined to adopt the following elements:

1. A factor that would have required registration for persons “routinely” making “roughly comparable” purchases and sales of the same or “substantially similar” securities in a day, which could have captured commonplace arbitrage strategies.
2. A bright line test that would have required registration as a government securities dealer (GSD) if a person engaged in trading volume of more than \$25 billion in government securities in each of four out of the prior six calendar months.
3. A requirement for firms to consider their activities by aggregating across other entities that they control or are under common control with.

Potential market impact

Treasury markets

A number of principal trading firms and private funds engaged in active trading of U.S. Treasury securities (USTs) may be required to register as GSDs or restructure their activities. The SEC estimates that up to 43 entities in UST markets will potentially be affected by the final rules, at least half of which are principal trading firms.

The SEC also estimates that principal trading firms not registered as GSDs account for about half of the daily volume in the interdealer market for USTs. If many of these firms alter their trading activity in USTs either to avoid registration or as a result of additional compliance burdens following registration (e.g., net capital requirements), liquidity may be affected

in UST markets.

Of note, “stand-alone” GSDs not also registered as securities broker-dealers must also comply with rules adopted by the Treasury Department on, among others, capital and liquidity requirements, modeled on those applicable to broker-dealers. We are not aware of any existing stand-alone GSDs and the relevant Treasury rules were adopted long ago at a time when market structure and the universe of relevant market participants were vastly different. If the final rules result in a number of new stand-alone registered GSDs, how these financial responsibility rules apply and whether they remain appropriate may need to be considered.

Private funds

While the final rules should capture many fewer private funds than the proposed rules would have, private fund managers should still consider whether their funds’ trading activities could cause the fund to be in scope. In particular, there are many vague terms and ambiguities in the final rules, among others:

- What activity constitutes a “pattern”?
- When is that pattern “regular”?
- How frequently constitutes “regularly” expressing trading interest?
- How close to the market is “near” the best price?
- When is a communication and representation of a trading interest considered to be made “in a way that makes it accessible”?
- If not trading on both sides of the market simultaneously, how close-in-time is “sufficient” that it provides liquidity?
- When is a source of revenue “primary”?

For many of these and other questions, the SEC suggests it depends on the “facts and circumstances,” the “totality of the activity,” or the particulars of the market—which may make it difficult for fund managers to have complete certainty about important judgment calls that will need to be made about a fund’s dealer status. It is unclear if the SEC will resolve these ambiguities by issuing guidance, or through enforcement actions or other means.

Digital assets

In response to comments, the SEC specifically noted that the final rules apply to persons purchasing and selling digital assets that are securities, including on decentralized trading platforms, to the same extent they apply to traditional securities and markets. In particular, because the SEC seems to take the position that that most digital assets are securities, even when traded in the secondary market (a position currently subject to litigation), persons acting as liquidity providers on decentralized finance automated market maker (AMM) systems could be dealers subject to registration. However, the SEC’s position assumes that the SEC is correct on the underlying law regarding whether a given digital asset is a security, or if secondary market transactions in digital assets can be securities transactions.

Law clerk Nausherwan Ahmed Aamir contributed to this client update.

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.

Mary Jane Dumankaya

+1 212 450 3654
maryjane.dumankaya@davispolk.com

Michael S. Hong

+1 212 450 4048
michael.hong@davispolk.com

Leor Landa

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

David L. Portilla

+1 212 450 3116
+1 202 962 7155
david.portilla@davispolk.com

Gabriel D. Rosenberg

+1 212 450 4537
gabriel.rosenberg@davispolk.com

Gregory S. Rowland

+1 212 450 4930
gregory.rowland@davispolk.com

Tyler X. Senackerib

+1 212 450 3419
tyler.senackerib@davispolk.com

Zachary J. Zweihorn

+1 202 962 7136
zachary.zweihorn@davispolk.com

This communication, which we believe may be of interest to our clients and friends of the firm, is for general information only. It is not a full analysis of the matters presented and should not be relied upon as legal advice. This may be considered attorney advertising in some jurisdictions. Please refer to the firm's privacy notice for further details.